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TRANSATLANTIC EXTRATERRITORIALITY AND THE REGULATION OF DERIVATIVES: THE NEED FOR AN INTEGRATED APPROACH BETWEEN WASHINGTON AND BRUSSELS, THE UNCERTAINTIES OF BREXIT AND NEW DIRECTIONS IN THE US

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ABSTRACT

This paper examines the common approach reached between Commodities Future Trading Commission (CFTC) and the European Commission (EC) on derivatives regulation. The paper reviews issues resolved and explores the issues that remain which are leading to fragmentation of the \$553tn global derivatives market. While many differences have been resolved, it would have been better for the markets had both the European Union [EU] and United States [US] adopted a collaborative approach when reforming derivatives after the Financial Crisis (2008). This decision of the EU and US to proceed separately and draw up their own respective versions of the over the counter [OTC] derivatives regulatory landscape was a misstep which affected the efficient operation of capital markets. The question now is whether co-operation between US and EU regulators can survive the disruption posed by Brexit and the Trump Administration and the new directions the UK and US might take in terms of derivatives regulation.

The long-term effect that Brexit may have on the regulation of derivatives will depend on the new post-Brexit relationship that the UK and the EU agree upon. It is essential that the smooth functioning of the international derivatives trading market and the critical role that London plays as the global centre for Euro denominated clearing must continue without regard to whether a political agreement can be reached on the withdrawal of the UK from the EU. A discussion as to the post-Brexit role that the City of London should play in respect of Euro denominated clearing and the services the City performs for EU clearing members and trading venues needs to be had to give the EU the assurance it requires to have oversight over central counterparties (CCPs) operating in third countries (such as post-Brexit UK) that perform systematically important functions for EU clearing members and trading venues.

In the US, if the Trump Administration can reform current CFTC regulation to reduce the extraterritorial impact that current US swaps trading rules have on non-US market participants, this could be beneficial to reduce the fragmentation that is occurring in the global swaps trading pool. It is encouraging to see CFTC Chairman Giancarlo propose implementing a two-tier system that would separate foreign jurisdictions into those that are “comparable” and those that are “non-comparable” in order to afford comparable jurisdictions greater control over their own regulatory matters so long as such matters do not pose a risk to the US financial system. However, such a reform will require Congress to act and they will look to what the EU is doing in respect of its European Market Infrastructure Regulation on derivatives, central counterparties and trade repositories (EMIR 2.2) reforms before committing the CFTC to reducing the control it asserts on non-US market participants. The role of European Security and Markets Authority (ESMA) and its plans to introduce EMIR 2.2 at this juncture will play a pivotal role in determining whether the possibility of further reducing the extraterritorial application of derivatives regulation globally will continue.

KEYWORDS

Brexit; CFTC; CCPs; comity; compliance; DCMs; Dodd-Frank; EC; EU; EMIR; EMIR 2.2; ESMA; euro-denominated clearing; extraterritoriality; financial regulation; G20; harmonisation; ISDA; market fragmentation; MiFID II; OTC derivatives; regulatory arbitrage; SEFs; Trump Administration, US, etc.

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1. Executive Summary

After the Financial Crisis (2008), events demanded a regulatory framework to manage the systemic risk posed by the derivatives market and its participants. The solution that the Group of Twenty [G20] came up with was to reform over the counter [OTC] derivatives, exchange-traded and cleared derivatives. The G20 came up with this solution working with global financial co-ordination bodies such as the Committee on Payments and Market Infrastructures - International Organization of Securities Commission [CPMI-IOSCO] and the Financial Stability Board [FSB]. In particular, the central clearing counterparty [CCP] requirements which have been introduced in this process has been enacted into regional and national regulation in the respective major economies. This “top-down” centralised approach was necessary in a world where contagion in globalised markets could result in unprecedented transmission of economic instability. The post-Financial Crisis approach adopted by the G20 called for a clear alignment of the laws of each jurisdiction such that there are fewer conflicts of law. This enables regulators to defer to one another, rather than seeking to enforce their own rules extra-territorially.

The extensive reforms in the regulation of OTC derivatives post-Financial Crisis marked the end of the public-private divide that had taken place over the previous fifteen years in which regulators on both sides of the Atlantic off-loaded much of their oversight functions to the private market.¹ Once the Financial Crisis hit, the race was on by various national and supranational regulators to implement the proposed reforms in accordance with the international consensus reached as stated in the G20 reforms for the derivatives market announced in 2009.² First out the door was the US offering, Title VII of The Dodd–Frank Wall Street Reform and Consumer Protection Act (Pub.L. 111–203, H.R. 4173 (Dodd–Frank or Dodd-Frank Act)) (2010). Sometime later, the European Union (EU) offered the European Market Infrastructure Regulation (EMIR). In the process of introducing the clearing mandate for standardised OTC derivatives, collateral requirements and higher capital charges for non-cleared bilateral OTC transactions, differences arose between the positions taken on both sides of the Atlantic.

The CFTC took a “belt and braces” approach to OTC derivatives in that the US not only wanted EU players to follow US rules and requirements when operating in the US but also to be subject to US regulatory oversight when operating abroad and dealing with US regulated entities. This approach was met with resistance by the EU’s regulator, ESMA, which

¹ Stefano Pagliaro (2012), “Who governs finance? The shifting public-private divide in the regulation of derivatives, rating agencies and hedge funds”, *European Law Journal*, 18(1), pp. 44-61. doi: 10.1111/j.1468-0386.2011.00585.x, available at: <http://openaccess.city.ac.uk/2574/1/WHO%20GOVERNS%20FINANCE.pdf> (accessed 9 December 2017).

² G-20 Information Centre, University of Toronto, Monk School of Global Affairs, G20 Leaders Statement: The Pittsburgh Summit, September 24-25, 2009, Pittsburgh, available at: <http://www.g20.utoronto.ca/2009/2009communique0925.html> (accessed 13 December 2017).

responded by offering its own structure that was in many respects as equally overreaching as that of the CFTC.³

The differing positions between the EU and US led to an impasse which focused on the issue of mutual recognition of CCPs. This dispute which lasted over three years contributed to increasing fragmentation in the OTC derivatives markets whereby transactions split along transatlantic lines with the net effect of segregating US based transactions and institutions from those of their EU counterparts. The substitution of a bilateral transaction with a pair of symmetric trades with a CCP that serves as a counterparty to both sides of the trade by subjecting all counterparties to initial margin (IM) and variation margin (VM) requirements is the essence of central clearing. While this reduces counterparty exposure and isolates participating counterparties (clearing members) from each other's default, the efficiency of such a centralised clearing system is distorted if fragmentation along national/international lines results from cumbersome regulatory regime recognition requirements.

With EU and US regulations in OTC derivatives more substantially aligned than before, the likelihood of firms trying to manipulate the system has been reduced. Having said that the complexities thrown-up by the United Kingdom [UK] leaving the EU will present CCPs and multilateral trading facilities (MTFs) (a EU-regulatory term for a self-regulated financial trading venues) based in the UK with additional complexities post-Brexit as these organisations may lose the benefits of passporting that EU based financial service entities enjoy, and may have to rely on an equivalence regime that offers less flexibility and a duration that can be curtailed based on short notice.

Across the Atlantic, the Trump Administration may use its desire to roll back aspects of Dodd-Frank to address some of the more unpopular aspects of derivatives reform that strike the industry as unduly burdensome in proportion to their benefit. While cutting back on regulation in these areas might be welcomed by US businesses, if these reforms go too far then regulators in other jurisdictions may question the sufficiency of US derivatives regulation and revisit the equivalence arrangements in place with the US. This could raise a number of issues in the case of the US and its relationship with the EU that might best be left alone.

This research examined two major themes:

First, are the differences between US and EU/UK approaches to derivatives regulation significant in nature or do they achieve basically the same result? How might these approaches be affected by Brexit in the UK or the Trump Administration in the US? For the period from 2013 to 2017, different regulatory approaches to derivatives regulation taken by the US and EU/UK created unnecessary complexity and inconsistent outcomes. While these issues have been resolved, some notable problems remain unaddressed. Moreover, Brexit presents us with the potential for a schism between the EU and UK over financial services and there is the possibility that the Trump Administration may de-regulate

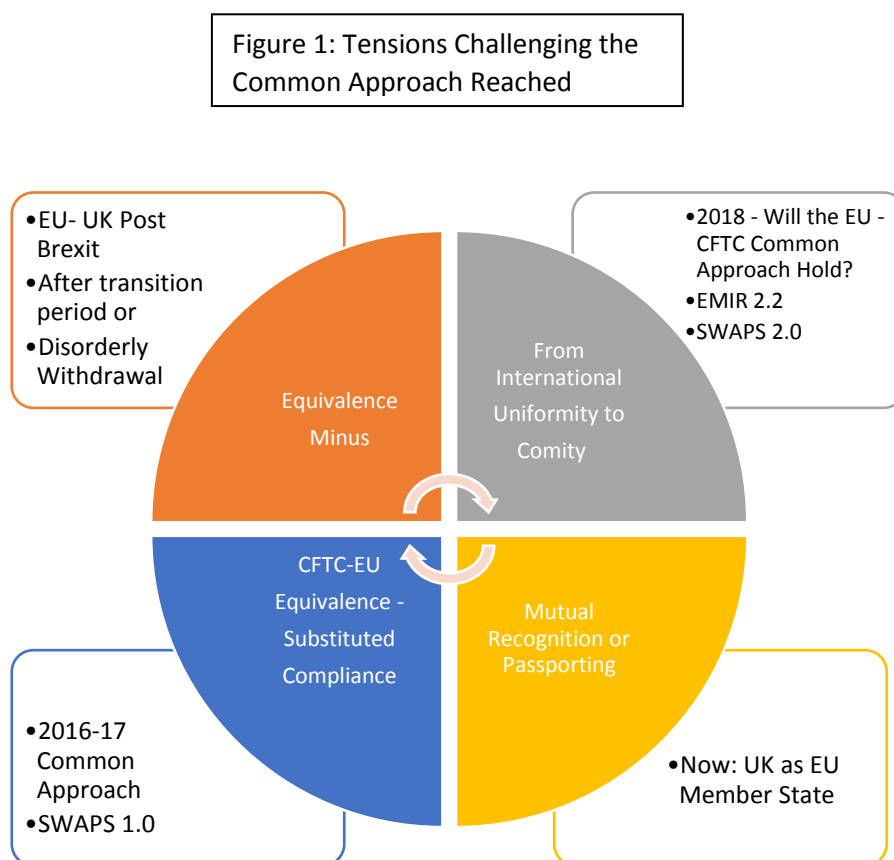
³ Luke Clancy, "Esma chair hits back against regulatory overreach claims", Risk.net, 14 February 2013, available at: <https://www.risk.net/regulation/emir/2243709/esma-chair-hits-back-against-regulatory-overreach-claims> (accessed 19 September 2018).

derivatives in order to give the US financial markets a competitive advantage over its global competitors.

Second, is there potential for banks to manipulate the system by taking advantage of looser regulation in some jurisdictions to avoid more stringent regimes elsewhere? For example, are there instances where a US entity might use the UK as a jurisdiction to remove some of their swap transactions off the CFTC and the SEC regulatory table? It has been suggested that some of the large global financial service providers redesigned their transactions to avoid US CFTC supervisory oversight. This research concludes that the likelihood of regulatory arbitrage will decrease over time if both the US and EU/UK regulatory regimes continue to work towards basic regulatory alignment in critical areas. Whether such alignment will hold going forward remains an open question.

The further we move away from the Financial Crisis the greater the will there is on the part of the national and supranational regulators to make sure such an event does not happen again. Regulators are currently far more cooperative with each other as a result. However, we have now entered a new period in politics in which multilateralism is viewed with a new scepticism. Will this threaten some of the achievements already reached between regulators?

Figure 1 below sets out a matrix that indicates the path of EU – US coordinated policymaking on the subject of derivatives regulation.



2. Introduction

a) Public Interest

The inflexible approach adopted at first by the various derivatives regulators demonstrates what happens when a national or supranational regulator pushes an agenda that is inwardly focused for political or protectionist purposes, at the expense of creating a common consensus with similarly situated regulators globally. The likelihood that financial regulators in different jurisdictions across the world can willingly or out of necessity work together for the furtherance of cross-border stakeholders cannot be assumed.

A truly integrated cross-border regulatory framework requires regulators to defer to other regulators when these other regulators are acting in their own home jurisdiction. There are, however, limitations to deference in the context of derivatives regulation. “Wholesale banking is international by nature. We risk kidding ourselves if we think it can be neatly chopped up into geographic units in which international banks can be supervised and resolved separately,” says Sam Woods, deputy governor of the Prudential Regulatory Authority.⁴ Woods uses the term “geofinance” to speak of the impact of borders, location and distance on the shape of banks, insurers and financial regulation. The political events of 2016 with the election of Donald J. Trump and the Brexit vote show us that political risk in mature democracies can also affect geofinance by disrupting the global rules-based international order that underpins geofinance.

The companies that operate in the geofinance space and the regulators that supervise them must recognise that the increase in political divides now being experienced in the EU, US and UK was a “predictable outcome” of the Financial Crisis.⁵ While there has been a recovery over the past decade, the long term political and social effects of the collapse are still being felt today.⁶ Simply put, there can be no room for complacency on the part of regulators to fail to ensure that the regulatory oversight of derivatives is done correctly.

b) Commercial Interests

This research examines the reforms to see what are the problems and opportunities posed by differing approaches to derivatives regulation between the EU and US. The potential impact from a failure of the EU and the US to take a “joined-up” approach to the regulation of this systematically critical element of global capital markets are considered. The research is important because the G20 OTC derivatives market reform agenda has reshaped

⁴ BoE, Speech by Sam Woods – Geofinance, Deputy Governor, Prudential Regulator and Chief Executive Officer, PRA, 4 October 2017, available at: <https://www.bankofengland.co.uk/-/media/boe/files/speech/2017/geofinance---speech-by-sam-woods.pdf?la=en&hash=1B7B8C099846ED4D305128BBB265F7BB71A354BA> (accessed 20 December 2017).

⁵ Gautum Mukunda, “The Social and Political Costs of the Financial Crisis, 10 Years Later”, Harvard Business Review, 25 September 2018, available at: <https://hbr.org/2018/09/the-social-and-political-costs-of-the-financial-crisis-10-years-later> (accessed 29 September 2018).

⁶ Ibid.

the structure of these markets in several ways in recent years.⁷ Even though the speed of implementation of the reforms has varied across jurisdictions, the impact on global OTC markets is already evident by the fact that central clearing of derivatives which was aimed at reducing counterparty risks has gained ground. The BIS [11 December] 2016 Triennial Survey (which marked the first-time data had been collected on the share of centrally cleared contracts) found that more than 70% of the gross notional amounts outstanding of OTC interest rate derivatives were centrally cleared as of June 2016 for all major currency segments.⁸ By contrast, the percentage of gross notional amounts outstanding of OTC interest rate derivatives cleared as of December 2007 was only 16.1%.⁹

The Financial Stability Board (FSB) reported [as of December 2016] a share of centrally cleared OTC interest rate derivatives turnover averaging approximately 76% of weekly aggregate transactions during the first half of 2016.¹⁰ As of June 2017, the notional amount of outstanding OTC derivatives contracts was \$542 trillion at end-June 2017, however, the gross market value of outstanding OTC derivatives contracts fell below \$13 trillion which was its lowest level since 2007.¹¹ Gross credit exposures, which adjust gross market values for legally enforceable bilateral netting agreements (but not for collateral), also fell to their lowest level since 2007. They declined to \$2.7 trillion at end-2017.¹² BIS estimated that minimum global clearing rates in 2010 accounted for about 40% for interest rate swaps [IRS] and 8% for credit default swaps [CDS].¹³ Data collected as of 2017 on US reporting entities by the CFTC indicates that about 85% of both new IRS rate swaps and new CDS are now cleared.^{14 15}

OTC derivatives, e.g., IRS and CDS, are bilateral contracts which subject the parties to the risk of the possibility of a default of a counterparty. OTC derivatives users manage their

⁷ Torstein Ehlers and Element Erin, The changing shape of interest rate derivatives markets, BIS Quarterly Review, December 2016, 11 December 2016, available at: http://www.bis.org/publ/qtrpdf/r_qt1612f.htm (accessed 28 December 2016).

⁸ BIS, Triennial Central Bank Survey of foreign exchange and OTC derivatives markets in 2016, 11 December 2016, available at: <http://www.bis.org/publ/rpfx16.htm> (accessed 28 December 2016).

⁹ ISDA Research Note Derivatives Market Analysis: Interest Rate Derivatives - January 2016, available at: <https://www.isda.org/a/wSiDE/derivatives-market-analysis-jan-2016-final3.pdf> (accessed 2 July 2018).

¹⁰ Philip Wooldridge, Central clearing predominates OTC interest rate derivatives, BIS Quarterly Review, 11 December 2016, pp. 22-4, available at: https://www.bis.org/publ/qtrpdf/r_qt1612r.htm (accessed 28 December 2016).

¹¹ BIS, OTC derivatives at end-June 2017, 2 November 2017, available at: https://www.bis.org/publ/otc_hy1711.pdf (accessed 18 August 2018).

¹² Ibid.

¹³ BIS, Statistical release: OTC derivatives statistics at end-December 2017, 3 May 2018), available at: https://www.bis.org/publ/otc_hy1805.pdf (accessed 11 September 2018).

¹⁴ CFTC, Speeches and Testimony, Remarks of Chairman J. Christopher Giancarlo at the Association of German Banks, Berlin, Germany, 7 May 2018, available at: <https://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo45> (accessed 11 September 2018).

¹⁵ New data collected from EU TRs pursuant to mandatory reporting requirements of EMIR now offers ESMA the opportunity to offer more comprehensive coverage of EU data as compared to that obtained from surveys used by BIS in preparing its Semiannual and Triennial derivatives statistics. See Yanis El Omari, Martin Haferkorn and Carsten Nommels, EU derivatives markets – a first-time overview, ESMA Report on Trends, Risks and Vulnerabilities No. 2, 2017 ESMA50-165-421, fn. 16, p. 7 available at: https://www.esma.europa.eu/sites/default/files/library/esma50-165-421_eu_derivatives_markets_-_a_first-time_overview.pdf (accessed 19 September 2018).

credit exposures through the use of netting agreements, margining or collateral requirements, tear-ups, cash resettlement as well as other bilateral credit-enhancing techniques. With the establishment of central clearing at the end of the 1990s, CCPs were introduced into the equation which helped market players limit or manage their credit risk. The OTC derivatives that have been negotiated between parties on an off-exchange basis are then re-booked into a clearinghouse which acts as a CCP much as they do in the exchange-traded futures and options world. In the simplest of terms, a CCP is a financial intermediary that sits in the middle of derivatives contracts: once a transaction has been agreed between two parties and registered with a CCP, the CCP inserts itself into the transaction (so that one contract becomes two - a process called “novation”) or is deemed to be an original party to the transaction (one transaction automatically generates two contracts - a process called “open order”) to become the buyer to every seller and the seller to every buyer.¹⁶

After the collapse of Enron in 2001, clearing of OTC derivatives grew exponentially in the energy sector. This was followed by developing cleared businesses in interest, equity, commodities and credit products. Once the Financial Crisis hit it became clear that there was a critical need for CCP clearing solutions for OTC derivatives. In the US, American International Group, Inc.’s [AIG] \$78 billion gamble in CDS written on multi-sector collateralized debt obligations (securities backed by debt payments from residential and commercial mortgages, home equity loans, etc.) proved catastrophic because AIG did not have any offsetting positions that would make money if the CDS lost money. The lack of reliable data about OTC derivatives positions meant that the US Government, in particular, did not have the essential information necessary to accurately gauge the implication of the failures of large financial concerns such as Bear Stearns (March 2008), Lehman Brothers (September 2008) and AIG (September 2008) on derivatives counterparties throughout the financial system.

At the same time the bankruptcy of Lehman Brothers revealed the complexity of settling creditor and counterparty claims relating to OTC derivatives owing to the special treatment these derivatives received under the US Bankruptcy Code through “safe harbor provisions” that alter non-bankruptcy entitlements.¹⁷ The effectiveness of the settlement procedures with respect to their speed, predictability, and transparency varied across claimant groups. Research revealed that for OTC derivatives transactions creditors’ recovery rate was below historical averages for failed firms comparable to Lehman.¹⁸ Equally problematic was the issue of the UK based entity Lehman Brothers International (Europe) where some of the collateral it held ended up subject to insolvency in jurisdictions other than that of the UK.

¹⁶ International Capital Markets Association, “27. What does a CCP do? What are the pros and cons?”, Available at: <http://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/short-term-markets/Repo-Markets/frequently-asked-question-on-repo/27-what-does-a-ccp-do-what-are-the-pros-and-cons/>

¹⁷ GuyLaine Charles, “OTC Derivative Contracts in Bankruptcy: The Lehman Experience”, NYSBA NY Business Law Journal, Spring 2009, Vol. 13, No. 1, 14 – 17, 14, available at: <http://teiglandhunt.com/wp-content/uploads/2009/04/OTC-Derivative-Contracts-in-Bankruptcy-GuyLaine-Charles.pdf> (accessed 20 August 2018).

¹⁸ Michael J. Fleming and Asani Sarkar, “The Failure Resolution of Lehman Brothers”, FRBNY Economic Policy Review / December 2014, available at: <https://www.newyorkfed.org/medialibrary/media/research/epr/2014/1412flem.pdf> (accessed 20 August 2018).

This complicated prompt resolution and recovery of collateral. The fact that insolvency law is a matter of national law means its interpretation and enforcement follows the line of sovereignty. If different collateral assets of the same entity are treated differently due to the jurisdiction where the particular collateral is located, this undermines consistent results.

When discussing the impact of bankruptcy, one must ask what would happen if a CCP collapses? For instance, in the UK would its government step in in such a collapse? How far would they go and for what outcome? In the case of a major default, how would the liabilities of this CCP be divided up? For instance, would the Bank of England [BoE] take on the full liability of a UK entity? Would the BoE get access to US dollar and Euro swap lines *in extremis*? If the BoE could not get such access, then the UK CCP would need to liquidate any US dollar or Euro non-cash collateral assets in a rush, arguably exacerbating a run on those markets, and likely triggering further collapses.

This hypothetical demonstrates the need for different national and supranational banking institutions, e.g., BoE, Federal Reserve [Fed] and the ECB, (a) to develop greater trust and reliance in each other; (b) to have contingency agreements and plans in place to deal with the risks posed by the case of a major CCP becoming insolvent; (c) to adequately quantify the risks introduced within their respective jurisdictions as well as the benefits accrued by such CCP activity; and (d) to move from a competitive mindset to a cooperative mindset between them when facing the possibility of a potential CCP collapse that might impact different jurisdictions simultaneously. Of course, none of this denies the reality that national and supranational jurisdictions do compete against each other and even threaten not to help each other in certain scenarios or when certain events happen with the hope of repatriating markets from abroad.

If a CCP take bonds of the government of its own country as collateral this is not a problem, e.g., one can expect a 5% discount for liquidity. However, this only goes so far in that a CCP is a commercial organisation and has to manage its risk – therefore such a CCP should discount even its own government’s bonds at least as much as the market does, with an extra bit for safety. Anything else would suggest that there is no risk management or an assumption of state aid which CCPs are not entitled to as commercial organisations. However, this flies in the face of “too big to fail” - so what is the right balance?

The problem with this is that there is a wariness with sovereign debt being discounted, just as much as there are concerns about taxpayers being forced to bail out CCPs after AIG and Lehman. How does one balance all of this with the ultimate goal of preserving financial stability?

c) What Should a CCP Be?

The above analysis goes to the heart of what should a CCP be. Is it the thing that allows a country’s financial services to operate, no matter what circumstances arise (and its government acting as a sovereign can print money for it in order to keep it in operation), or is it a commercial risk management organisation independent from the state and at the mercy of shareholders?

This question has not been properly posed, much less answered. To make matters worse, even if it had been answered, at a macro level, how would you answer it in the context of an international currency, like the Euro? Should all Euro trades and collateral be booked through and accepted only at CCPs of the issuing country or should any CCP in the Eurozone area accept any Euro trades and collateral? In times of trouble, it is arguable that in the former case the country might end up bypassing Euro system disciplinary obligations but in the latter case Eurozone Member States would effectively end up backing another Eurozone Member State.

d) Private Regulation

Private regulation in the form of professional groups that ensure contract terms is a major factor in the derivatives industry as the International Swaps and Derivatives Association (ISDA) has succeeded in the past thirty years in ensuring that around 90% of all OTC derivatives are now governed by its documentation. These ISDA templates standardise language, reduce transaction costs, simplify negotiations, bolster legal certainty and make it easier for transacting parties to enter into contractual relations. ISDA brought order to the OTC market, but it did so via contract law, giving to market participants the tools needed to structure their transactions and enable market activity.¹⁹

ISDA issued a whitepaper published in September 2017²⁰ on cross-border harmonisation (2017 ISDA Cross-Border Whitepaper) in which it suggested that a re-think of the operation of Section 2(i) of the Commodity Exchange Act (CEA) is necessary in respect of its application to assert extraterritorial jurisdiction. This section should be seen as a limitation and not as an invitation to regulate all global derivatives transactions with any nexus to the US. For instance, a swap transaction between two swap dealers operating outside the US that is arranged and negotiated by personnel located in the US, but executed, cleared and reported outside the US, has a direct connection to US commerce.²¹ In ISDA's view, such a transaction with a limited nexus to the US should fall "well outside" of CFTC jurisdiction. However, the CFTC Cross-Border Guidance²² picks up this transaction as well as almost all cross-border transactions and then applies the entire Dodd-Frank Title VII framework to them placing almost every entity around the world engaged in derivatives trading subject to CFTC registration and US regulatory oversight for most derivatives transactions.²³

The optimal regulatory outcome identified by ISDA would be that Section 2(i) of the CEA would be read so that only cross-border swap transactions that directly impact the CFTC's regulatory interests would be within the scope of its jurisdiction. For all other transactions,

¹⁹ Bruce G. Carruthers, *Financialization and the institutional foundations of the new capitalism*, Northwestern University and the University of Chicago, *Socio-Economic Review*, 2015, *Socio-Economic Review*, 2015, Vol. 13, No. 2, 379–398, 20 April 2015.

²⁰ ISDA, *Whitepaper CROSS-BORDER HARMONIZATION OF DERIVATIVES REGULATORY REGIMES: A risk-based framework for substituted compliance via cross-border principles*, September 2017, available at:

<https://www.isda.org/a/DGiDE/isda-cross-border-harmonization-final2.pdf> (accessed 18 August 2018).

²¹ *Ibid.*

²² CFTC Cross-Border Guidance, *op cit.*

²³ *Ibid.*

CFTC should have to rely on a substituted compliance regime that is based on an assessment of the risk-related rules of a foreign jurisdiction against sound risk-based cross-border principles proposed by ISDA in the whitepaper. This view is similar to that expressed by CFTC Chairman Giancarlo who suggests that the “CFTC’s cross-border approach too often has been over-expansive, unduly complex and operationally impractical.”²⁴

When setting up their respective OTC derivatives regulatory frameworks after the Financial Crisis, EU and US regulatory authorities took steps to pre-empt the likelihood of these frameworks being frustrated by regulatory arbitrage by adopting different degrees of extraterritoriality application of their regulatory structure. In practice, however, the application of appropriate EU and US mutual recognition tools has frequently failed to rein back the extraterritorial application of these respective regulatory regimes’ rules.²⁵ Gravelle and Pagliari (2018)²⁶ suggest that a strong prudential imperative has frequently overridden other forces to influence the extent to which authorities have been willing to extend the scope of their regulatory authority over foreign firms. These include the commercial incentive to either protect domestic market actors or “level the playing field” (the preferences of transnational market participants to avoid duplicative requirements), and the role of transnational regulatory institutions in promoting greater deference to each other’s rules.²⁷

3. Background

a) The CFTC-EC Current Resolution

i) The CFTC-EC Common Approach (2016)

On 10 February 2016, the US and EU announced that they reached an agreement to adopt a CFTC-EC Common Approach (2016) to the regulation and supervision of the global derivatives markets to ensure that EU CCPs are able to do business in the US more easily and that US CCPs can continue to provide services to EU companies.²⁸ On 15 March 2016, the EC determined that the CFTC had the equivalent requirements as the EU in regulating CCPs.²⁹ This decision ensured that both EU and US CCPs operate to the same standards alleviating the regulatory burden for US and EU CCPs by allowing compliance with only one

²⁴ CFTC, Speeches & Testimony – Keynote Address of CFTC Commissioner J. Christopher Giancarlo Before SEFCON VII, 18 January 2017, available at:

<https://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo-19> (accessed 18 January 2018).

²⁵ Matthew Gravelle and Stefano Pagliari, “Global Markets, National Toolkits: Extraterritorial Derivatives Rule-Making in Response to the Global Financial Crisis”, Chapter 3, pp. 82-108, 83, 108, published in Eric Helleiner, Stefano Pagliari, and Irene Spagna, eds., “Governing the World’s Biggest Market: The Politics of Derivatives Regulation After the 2008 Crisis”, New York: Oxford University Press, 2018 [ISBN 978-0-19-086457-6]

²⁶ The authors note that the paper’s analysis is up to date as of 16 December 2015.

²⁷ Gravelle and Pagliari, op cit.

²⁸ EC Press Release, “EC and the US CFTC: Common approach for transatlantic CCPs”, 10 February 2016, available at: http://europa.eu/rapid/press-release_IP-16-281_en.htm (accessed 14 April 2016).

²⁹ EC Press Release, “EC adopts equivalence decision for CCPs in USA”, 15 March 2016, available at: http://europa.eu/rapid/press-release_IP-16-807_en.htm (accessed 2 May 2016).

set of rules thereby promoting market certainty and cross-border activity while avoiding fragmentation of markets and liquidity. This action by the EC meant that US CCPs, once recognised by the EC, can continue to provide services to EU companies.

Following on from the EC action came the US CFTC's decision on substituted compliance made on 16 March 2016 which allows European CCPs to do business in the US more easily. European CCPs registered with the CFTC can comply with many of the CFTC rules by meeting the corresponding EMIR requirements.³⁰ The implications of the CFTC action are as follows: certain rules have been identified for which the CFTC will grant substituted compliance - CCP financial resources, risk management, settlement procedures and default management. The process for registration for EU-based entities has also been streamlined; at the same time, CFTC staff have been authorised to provide “no-action” relief from the application of CFTC regulations to discrete aspects of a clearinghouse’s non-US clearing activities.

With the equivalence agreement in place agreed to by both EC and US regulators, a critical step in achieving transatlantic cross-border harmonisation of derivatives regulation has been achieved. The foundation for cooperation between regulators in the oversight of the global clearinghouses is one step along the path to resolve years of impasse standing in the way of the EU recognising US CCPs and *vice versa*.

CCPs registered with the CFTC will now be able to obtain recognition in the EU. Market participants will be able to use them to clear standardised OTC derivative trades as required by EU legislation, while the CCPs will remain subject solely to the regulation and supervision of their home jurisdictions (in this case, the US). A CCP wishing to obtain recognition must apply to ESMA. ESMA will then process the application in cooperation with the relevant regulators of the CCP that has applied for recognition. Under this equivalence decision, US CCPs seeking recognition in the EU will need to confirm that their internal rules and procedures meet certain conditions set out in the decision relating to the calculation of IM and the default fund.

Although the rules may differ in the detail, international regulators are pursuing similar objectives to promote financial stability by promoting the use of CCPs that are subject to robust prudential requirements. Using deference, as agreed by the G20, regulatory gaps, duplication, conflicts and inconsistencies which can lead to regulatory arbitrage and market fragmentation should be limited. The CFTC-EC Common Approach (2016) is in marked contrast to years of sharp disagreement between Washington and Brussels on how best to implement in their respective jurisdictions the broad international principles announced by the G20 in 2009 designed to improve transparency in the derivatives markets and mitigate systemic risk of exposure to them.

ii) The 2017 Derivatives Trading Venues Common Approach

On 13 October 2017, the CFTC announced determinations by the CFTC and the EC on comparability and equivalence of margin requirements for uncleared swaps as well as a

³⁰ CFTC Speeches and Testimony, Statement of CFTC Chairman Timothy Massad regarding Substituted Compliance Determination for the European Union, 16 March 2016, available at: <http://www.cftc.gov/PressRoom/SpeechesTestimony/massadstatement031616> (accessed 2 May 2016).

common approach regarding certain CFTC and EU authorized derivatives trading venues [The 2017 Derivatives Trading Venues Common Approach]. The EC adopted an equivalence decision for the CFTC's margin framework for uncleared derivatives and the CFTC has issued a decision concluding that the EU margin rules are comparable to the CFTC rules. In this regard, EU firms may rely on substituted compliance with EU margin rules to meet CFTC requirements.³¹ CFTC Commissioner Brian Quintenz indicated that the Trump Administration was taking a more pro-active stance than the Obama Administration to achieve comparability and equivalence with an outcomes-based approach to comparability determinations that was sorely lacking during the prior administration.³²

On 13 October 2017, the CFTC Commissioners approved a comparability determination finding the margin requirements for uncleared swaps under the laws and regulations of the EU comparable in outcome to those under the CEA and CFTC regulations.³³ Pursuant to the CFTC's comparability determination, a swap dealer or major swap participant that is subject to the both the CFTC's and EU's margin rules with respect to an uncleared swap may rely on substituted compliance wherever available under the CFTC's margin rules. Any such swap dealer or major swap participant that complies with the EU's margin rules would be deemed to follow the CFTC's margin rules, but would remain subject to the CFTC's examination and enforcement authority.

The CFTC's comparability determination rendered moot CFTC Staff Letter No. 17-22, in which the CFTC's Division of Swap Dealer and Intermediary Oversight provided time-limited no-action relief from compliance with certain provisions of the CFTC's margin rules for swap dealers that entered into swaps with counterparties that were subject to the EU's margin rules. The action of the CFTC coincided with the EC's announcement of an equivalence decision which similarly finds that the CFTC's uncleared swap margin rules are comparable in outcome to the EU's corresponding margin requirements for uncleared OTC derivatives.³⁴

The practical benefits of the 13 October 2017 margin requirements for uncleared swaps announcement declared equivalency for financial firms is limited in that there are high costs involved in assessing whether the relief is available.³⁵ While the US substituted compliance

³¹ CFTC, Federal Register No. 48394, Vol. 82, No. 200, Wednesday, October 18, 2017, Rules and Regulations, available at: <http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2017-22616a.pdf> (accessed 10 January 2018).

³² CFTC Press Release - pr7629-17, CFTC Comparability Determination on EU Margin Requirements and a Common Approach on Trading Venues, 13 October 2017, available at: <http://www.cftc.gov/PressRoom/PressReleases/pr7629-17> (accessed 10 January 2018).

³³ Ibid.

³⁴ Commission Implementing Decision (EU) 2017/1857 of 13 October 2017 on the recognition of the legal, supervisory and enforcement arrangements of the United States of America for derivatives transactions supervised by the Commodity Futures Trading Commission as equivalent to certain requirements of Article 11 of Regulation (EU) No 648/2012 of the European Parliament and Council on OTC derivatives, central counterparties and trade repositories (Text with EEA relevance.) C/2017/6572 In force OJ L 265, 14.10.2017, p. 23–27 (BG, ES, CS, DA, DE, ET, EL, EN, FR, HR, IT, LV, LT, HU, MT, NL, PL, PT, RO, SK, SL, FI, SV) ELI: http://data.europa.eu/eli/dec_impl/2017/1857/oj (accessed 10 January 2018).

³⁵ Julia Goatproof, "What's in a Name? A Practical Approach to EU/CFTC Margin Rules Equivalence?", 2 November 2017, University of Oxford – Faculty of Law Blog – Opinion, available at: <https://www.law.ox.ac.uk/business-law-blog/blog/2017/11/whats-name-practical-approach-eucftc-margin-rules-equivalence> (accessed 10 January 2018).

regime allows covered swap entities to follow alternative EU margin rules when transacting in non-centrally cleared OTC swaps, the EU equivalency does not grant a complete relief of substituted compliance but instead provides for partial equivalence instead.³⁶ While both sets of margining rules for non-centrally cleared derivatives were developed based on the Basel Committee on Banking Supervision (BCBS)/International Organization of Securities Commissions (IOSCO) IM framework to reduce systemic risks by ensuring that collateral is available to offset losses associated with these, there is substantial divergence that produces high compliance costs of adherence to different margin regimes operating internationally.³⁷

The 2017 Derivatives Trading Venues Common Approach follows the same tact adopted in the CFTC-EC Common Approach (2016). First, the EC agrees to adopt an equivalence decision to recognise CFTC-authorized swap execution facilities (SEFs) and designated contract markets (DCMs) that operate in the US as eligible venues for the execution of those derivatives transactions that will be subject to the EU trading obligation, provided the requirements of MiFIR, MiFID II and the Market Abuse Regulation are met. Second, the CFTC follows with an exemption of EU authorized swap trading venues (for this purpose, MTFs and organized trading facilities (“OTFs”)), from the requirement to register with the CFTC as SEFs, provided that they satisfy the standard set forth in CEA Section 5h(g). This renders the exempt EU venues operating in the EU eligible venues for purposes of complying with the CFTC trade execution requirement.

On 5 December 2017 the EC adopted a decision recognising certain trading venue authorised by the CFTC as eligible for compliance with the EU trading obligation for derivatives.³⁸ This decision ensures that EU counterparties can trade the derivatives instruments that are subject to the trading obligation, such as IRS and index-based CDS, on CFTC authorised DCMs and SEFs in the US. This decision does not affect the ability of EU counterparties to continue to trade on any CFTC-authorized SEF or DCM with respect to those derivatives which are not subject to the EU’s trading obligation.

In line with the 2017 Derivatives Trading Venues Common Approach, CFTC staff recommended that the CFTC issue an order of exemption from the CFTC’s SEF registration requirement [CFTC SEF Order of Exemption], with respect to MTFs and OTFs authorized in the EU.³⁹ The order enables US counterparties to comply with the CFTC’s trade execution requirement, by executing swaps subject to that requirement on MTFs or OTFs that have been exempted by the order. These MTFs and OTFs also would be able to offer trading in swaps that are not subject to the CFTC’s trade execution requirement to US counterparties.

³⁶ Ibid.

³⁷ Ibid.

³⁸ CFTC and EC, Joint Statement - EU and CFTC: Mutual Recognition of Derivatives Trading Venues, 5 December 2017, available at: https://ec.europa.eu/info/sites/info/files/171205-joint-statement-ec-cftc_en.pdf (accessed 5 December 2017).

³⁹ CFTC, Order of Exemption from of MTF and OTF Authorized Within the EU from the Requirement to Register with the CFTC as SEF, 8 December 2017, available at: [//www.cftc.gov/sites/default/files/idc/groups/public/@requestsandactions/documents/ifdocs/mtf_otforder12-08-17.pdf](https://www.cftc.gov/sites/default/files/idc/groups/public/@requestsandactions/documents/ifdocs/mtf_otforder12-08-17.pdf) (accessed 18 August 2018).

The EU now will allow banks and other traders in the EU to use US platforms to comply with MiFID II restrictions on derivatives which will work to prevent “a rupture” in the \$542 trillion global market with MiFID II now in effect. The move allows European traders to use some of the world’s biggest platforms run by CME Group Inc. and Intercontinental Exchange Inc., as well as more than 20 swap-execution facilities registered in the U.S., including those operated by BGC Partners Inc. and Cie. Financiered Tradition SA.⁴⁰

Although the 2017 Derivatives Trading Venues Common Approach is a significant step towards cross-border recognition of derivatives rules, some problems remain that impact on harmonisation of global derivatives trading. At the present time, there is the absence of equivalency for clearing, reporting and registration-related requirements. This creates operational complexities, competitive disadvantages and regulatory burdens without commensurate risk-reducing benefits. ISDA has recommended to regulators that they issue wholesale comparability determinations, using a risk-centred, outcomes-based approach.

In April 2018, ISDA issued A Practical Guide to Navigating Derivatives Trading on US/EU Recognized Trading Venues⁴¹ which made a number of practical observations and recommendations in respect of the 2017 Derivatives Trading Venues Common Approach. In terms of clearing, US and EU persons must still comply with their home-country clearing rules when executing trades on EU MTFs or OTFs and US SEFs owing to a lack of foreign clearing rules. As a result, global firms operating in both the US and EU must have systems in place that facilitate clearing through both the US agency and EU principal-to-principal clearing models in compliance with reporting regimes, the application of which may be a function of which venue is chosen, which seems arbitrary. ISDA has recommended that clearing rules being redesigned to allow for comparability using an outcomes-based methodology so once such a determination is made it does not require compliance with specific rules of a foreign jurisdiction’s clearing regime.

In terms of real-time reporting, the EU permits EU persons to comply with US real-time reporting rules in lieu of EU post-trade transparency obligations in certain circumstances (based on an equivalence assessment) although the CFTC has not yet reached an equivalent determination. This means that trades executed on MTFs/OTFs between US and EU counterparties may be disseminated to the public twice and at different times. While the CFTC SEF Order of Exemption is a good starting point, more work needs to be done. For instance, on the regulatory reporting side there is a lack of comparability in reporting regimes and entities subject to both regimes must report certain details of their trades executed on MTFs/OTFs to multiple entities within various time frames. The lack of reporting equivalency is a major burden for both US counterparties and non-US swap dealers, US buy-side firms in one direction and for EU investment firms and EU counterparties going in the other direction. The CFTC and EC have proposed steps to make it easier for foreign regulators to access their respective trade repositories (TRs) but for business the solution must be that the US and EU regulatory reporting regimes should be deemed equivalent.

⁴⁰ Silla Brush and Alexander Weber, MiFID Swaps Deal Reached for US Platforms to Avert Rupture, Bloomberg, 5 December 2017, available at: <https://www.bloomberg.com/news/articles/2017-12-05/mifid-derivatives-equivalence-granted-to-u-s-to-avoid-rupture> (accessed 6 December 2017).

⁴¹ Ibid.

b) UK – Brexit⁴²

i) Article 50 is Triggered

Today, the UK is part of the EU. However, following the British decision to invoke Article 50 of the Treaty of the EU (TEU) and leave the EU by 29 March 2019⁴³, is there now an incentive post-Brexit for the UK to arbitrage between the requirements imposed by US regulators on the one hand and EU regulators on the other hand? Increased regulatory arbitrage on the part of the UK has now entered the realm of possibility as the UK financial services industry faces the prospect of going it alone in a post-Brexit world. It can be said that Brexit has brought this research project back into the spotlight as now it may offer signposts as to what might be achievable in terms of appropriate available regulatory arbitrage mechanisms in the derivatives field for the UK should it wish to differentiate itself from the common regulatory scheme in force across EU Member States for derivatives.

However, a limiting factor to this newfound freedom is the fact that the UK was a key player in developing and implementing the G20s goals in respect of reform of OTC derivatives in response to the Financial Crisis. In this regard, the UK cannot be seen to roll-back efforts it played a key role in both proposing and implementing. Luca Enriques (2016) points out that the bigger problem is the issue of political uncertainty of the post-Brexit referendum environment in the UK. Such uncertainty may in the short to medium term make it harder for the UK to rebrand itself as a regulatory haven at the border of the EU.⁴⁴

It is an important point that at the present time the UK accounts for more than 75% of daily trading in Euro-denominated derivatives. Executive Board Member of the Bundesbank, the German Central Bank, Dr Andreas Dombret, stated on 29 November 2017 that "intensive cooperation" is necessary for Brexit to proceed without disruption to financial services to obviate the need for a large-scale relocation of clearing business to the EU in order for Europe to remain a stable place to do business and raise finance. This call for urgent action was echoed in *The Economist* which highlighted the fact that The City handles a big chunk of the market, including 39% of the market in interest-rate derivatives alone, where global daily turnover averages \$3trn. The rest of the EU accounts for just 9%.⁴⁵

⁴² A full discussion of the implications of Brexit for UK financial services is beyond the scope of this paper. However, readers may want to look at: Alexander Kern, Catherine Barnard, Eilís Ferran, Andrew Lang and Niamh Moloney, *Brexit and Financial Services: Law and Policy* (London: Bloomsbury Publishing, 2018).

⁴³ Letter from Rt Hon Theresa May, Prime Minister of the UK, dated 29 March 2017, to Donald Tusk, President of the European Council, available at: <http://www.telegraph.co.uk/news/2017/03/29/article-50-brexit-letter-read-full/> (accessed 6 August 2017).

⁴⁴ Luca Enriques, "Why the UK Has Currently Little Chance to Become a Successful Tax or Regulatory Haven", 7 July 2016, University of Oxford, Faculty of Law, Blog, available at: <https://www.law.ox.ac.uk/business-law-blog/blog/2016/07/why-uk-has-currently-little-chance-become-successful-tax-or> (accessed 2 January 2017).

⁴⁵ *The Economist*, "Standing novations: Brexit will give derivatives market a nasty headache: The legal status of thousands of contracts may be in doubt", Print edition, 12 October 2017, available at: <https://www.economist.com/finance-and-economics/2017/10/12/brexit-will-give-the-derivatives-market-a-nasty-headache> (accessed 10 July 2018).

ii) BoE Warnings on Derivatives

The Financial Planning Committee [FPC] of the BoE warned [28 June 2018] that the biggest risk to disruption to financial markets from Brexit exists where action is needed by both UK and EU authorities to ensure the continuity of existing derivative contracts.⁴⁶ A temporary permissions regime advocated by the BoE for the period after 30 March 2019 (Withdrawal Date) to address this problem has not yet been agreed. In the event that the EU-UK do not reach a withdrawal agreement [Withdrawal Agreement], some outstanding contracts may have to be shifted into the EU in the absence of such an exemption.

Volker Brühl's research on the relocation of Euro-clearing from the UK points out that further thought will have to be had as to whether the existing derivative contracts should remain in the UK with an obligation to clear Euro OTC derivatives arising under new contracts to be cleared through an EU CCP.⁴⁷ This would involve a transition period of several years for IRS which can only be provisionally estimated at this point. Brühl cites data from Swap Clear which indicates that over 50% of the outstanding volume will reach maturity within two years; a further 20% will reach maturity in 2 to 5 years; and finally, less than 10% of the volume has a maturity date of over 10 years.⁴⁸ As such, a transitional period of 5 years in length would be appropriate.

The FPC spoke of the need to ensure approximately £29tn of outstanding uncleared derivatives contracts could continue.⁴⁹ However, this figure is seen by Philip Stafford as a "red herring as just under half will mature before next March, plus it is a notional number."⁵⁰ The fact that notional amounts are still used to describe the size and risks of the global IRS markets give a misleading picture of the true size of markets for swaps and derivatives and sow confusion about their systemic risk profile.⁵¹ Stafford points out that Brexit does not automatically mean that all contracts are voided but there is the full expectation for legal obligations on existing derivatives contracts to continue. However, what the FPC is referring to is some activity involving derivatives that is outside of legal contractual obligations which is about a quarter of the total contracts involved.

⁴⁶ BoE FPC, Financial Stability Report, June 27, 2018, Issue No. 43, pp. 8 et seq., available at: <https://www.bankofengland.co.uk/-/media/boe/files/financial-stability-report/2018/june-2018.pdf> (accessed 28 June 2018).

⁴⁷ Brühl, op cit.

⁴⁸ Ibid.

⁴⁹ BoE, Financial Stability Report, November 27, 2017, Issue No. 42, available at: <https://www.bankofengland.co.uk/-/media/boe/files/financial-stability-report/2017/november-2017.pdf?la=en&hash=F6D-65F714A7DC28394BC4FCC9909CCD39E28AD10> (accessed 7 July 2018).

⁵⁰ Philip Stafford, "BoE's Brexit derivatives markets warning not as dire as it sounds: Notional numbers in this area are among financial markets' most abused statistics", FT, 28 June 2018, available at: <https://www.ft.com/content/e47d1828-7a0d-11e8-8e67-1e1a0846c475> (accessed 3 July 2018). According to Stafford, the industry uses the £29tn figure "to inflate its own importance and size of its market, and was aided by a media looking for sensational figures. It is not a measure of actual market or counterparty credit risk. Most swaps positions are **netted** off and the real number of affected contracts is much lower, perhaps in the billions."

⁵¹ CFTC, Speeches & Testimony, Remarks of Chairman J. Christopher Giancarlo before Derivcon 2018, New York City, New York, February 1, 2018, available at: <https://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo35> (accessed 10 July 2018).

The BoE numbers include activity such as compression which involves the offsetting of contracts that have large notional values but no market risk. Compression allows banks to reduce their exposure to their derivative portfolios in order to ensure that these banks meet tougher capital rules.⁵² While some banks may have to shift outstanding contracts into the EU which could be time-consuming and burdensome, the exemption proposed by the BoE for existing contracts in a Withdrawal Agreement would resolve the problem assuming such a Withdrawal Agreement is reached. Under the rules in six large EU Member States, novations and compressions would be considered regulated activities, but without a “passport” or an equivalence decision these options would no longer be open to British counterparties. Unable to readjust their “legacy” portfolios left in London, EU firms would struggle to manage the risks from such contracts.⁵³

The EBA’s position on this is that it is now the time for individual financial institutions to take the necessary steps to ensure that their contracts are protected from a disorderly withdrawal of the UK from the EU on 30 March 2019 without a Withdrawal Agreement in place [Disorderly Withdrawal]. BoE Governor, Mark Carney, however, is critical of the EBA approach suggesting that private financial institutions on their own are capable of mitigating the risks of a Disorderly Withdrawal. For instance, for any financial institution involved with the derivatives sector, thousands of clients would need to agree to such contractual changes and past experience suggested any process of rewriting contracts and transferring them to the EU could take up to four years.⁵⁴ ESMA Chairman Steve Maijor stated on 3 October 2018 that negotiations are now taking place between the UK Financial Conduct Authority (FCA) (which includes the BoE’s prudential regulatory authority) and ESMA (who is leading this effort for the EU working in coordination with the EU 27 national regulatory authorities) to reach a bilateral agreement to be operational in the event of a Disorderly Withdrawal.⁵⁵

ESMA’s solution to address BoE Governor Carney’s concerns was announced on 8 November 2018 and is a plan to provide a twelve-month window for the novation of non-centrally cleared OTC derivative contracts (such as certain types of IRDs and CRDs) to be open for twelve months following a Disorderly Withdrawal of the UK from the EU.⁵⁶ This would address the scenario that under a “no-deal” some contracts that are traded privately between banks would be legally required to be routed through CCPs at a higher cost.⁵⁷ ESMA Chairman Maijor said: “ESMA and other EU authorities and institutions have been

⁵² Stafford, op cit.

⁵³ ISDA, *derivatiViews: Brexit and contractual certainty*, 9 October 2017, available at: <https://www.isda.org/2017/10/09/brexit-and-contractual-certainty/> (accessed 10 July 2018).

⁵⁴ Chris Giles, “BoE hits out at Brussels over post-Brexit plans: Central bank says bloc has not done enough to ensure financial stability in case of hard Brexit”, FT, 27 June 2018, available at: <https://www.ft.com/content/05d69d30-79ed-11e8-bc55-50daf11b720d> (accessed 3 July 2018).

⁵⁵ Philip Stafford, “EU regulators draft market agreements with UK’s FCA Talks for memorandum of understanding begin as fears grow over no-deal Brexit”, FT, 3 October 2018, available at: <https://www.ft.com/content/5b448e12-c6f0-11e8-ba8f-ee390057b8c9> (accessed 7 October 2018).

⁵⁶ Philip Stafford, “EU plans reprieve to derivatives deals to avoid Brexit chaos Regulators will allow temporary exemptions to prevent disruption to thousands of uncleared derivatives contracts”, FT, 8 November 2018, available at: <https://www.ft.com/content/c1237580-e370-11e8-a6e5-792428919cee> (accessed 9 October 2018).

⁵⁷ *Ibid.*

clear on the importance for market participants to be prepared for Brexit, including the possibility of a no-deal scenario. The proposed regulatory change supports counterparties' Brexit preparations and maintain a level playing field between EU counterparties, while addressing potential risks to orderly markets and financial stability."⁵⁸ ESMA's guidance on this point is very clear in that counterparties need to be "repapering their contracts ahead of the application date, making the novation conditional upon a no-deal Brexit, given the conditional application date of the proposed amendments." The proposed amendments have been submitted to the EC for endorsement and are then subject to the scrutiny of the European Parliament and the European Council.⁵⁹

iii) The Chequers Plan

The Statement from HM Government, Chequers, 6 July 2018 [Chequers Statement], acknowledges that in terms of financial services the UK is keen to make arrangements that preserve the mutual benefits of integrated markets and protects financial stability while acknowledging that the future arrangements will not replicate the current EU's passporting regimes. However, a coordinated approach leading to compatible regulation is in the view of the UK Government a necessary reality to support financial stability and avoid regulatory arbitrage. This is because the UK Government believes that third country equivalence regimes which provide limited access for some EU third country partners to some areas of EU financial services markets are insufficient for a third country such as the UK whose financial markets are so deeply interconnected with those of the EU. The UK Government has accepted that the EU can ultimately decide whether UK financial services rules are equivalent to its own, with no further right of appeal — a stance that in effect gives the EU veto power over some UK financial reforms if it wants to retain access to the European market.⁶⁰ In simple terms, the EU does not want to give the UK more influence over the EC's equivalence decisions as a third country than it had as a Member State. Consequently, the UK clarification that its proposals for overall governance arrangements, described in Chapter 4 of the Chequers Statement, were not intended to cover proposals on financial services outlined in Chapter 1 was seen as helpful.⁶¹

In testimony before the House of Commons (HC) Treasury Select Committee on 17 July 2018 BoE Governor Mark Carney expressed the view that a Disorderly Withdrawal whereby the continuity of derivatives contracts was not assured would lead to EU banks and corporations acting *ultra vires* in using London-cleared derivatives which would force them to make other arrangements incurring significant cost and market disruption: "This is very important plumbing in the financial system and we're concerned that the EU has not yet indicated its solution. It's cold comfort, but it will be worse in Europe than here [if a deal were not

⁵⁸ ESMA, ESMA proposes a regulatory change to support the Brexit preparations of counterparties to uncleared OTC derivatives, 8 November 2018, available at: <https://www.esma.europa.eu/press-news/esma-news/esma-proposes-regulatory-change-support-brexit-preparations-counterparties> (accessed 8 November 2018)

⁵⁹ Ibid.

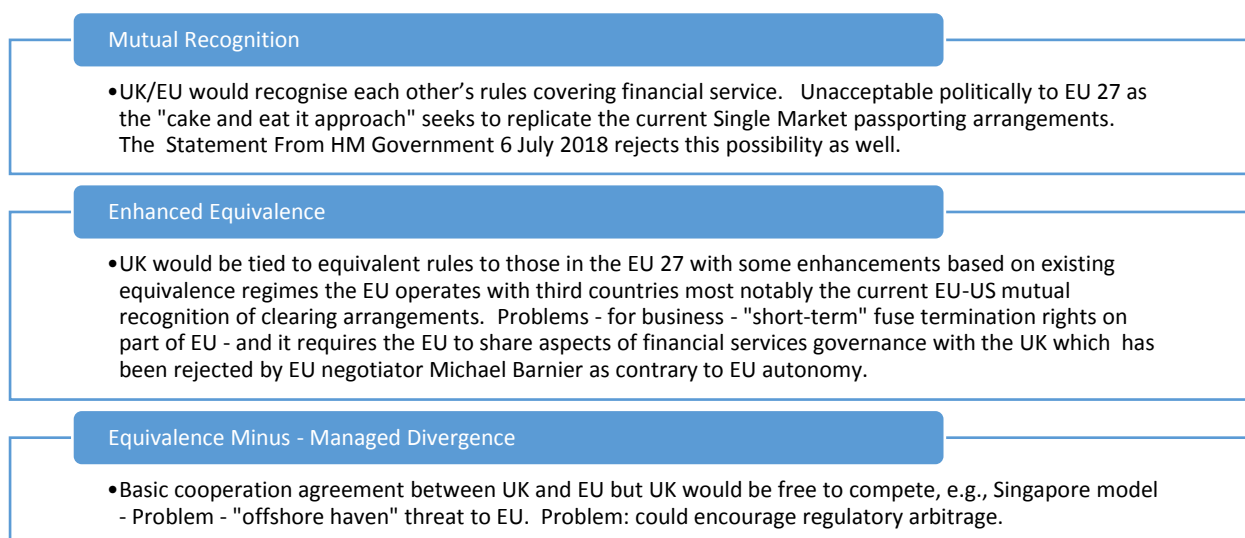
⁶⁰ Alex Barker, "Barnier eases opposition to May's Brexit plan for City of London: UK concedes Brussels' ultimate control over financial services access to Europe", FT, 30 July 2018, available at: <https://www.ft.com/content/4dd41028-9328-11e8-b67b-b8205561c3fe> (accessed 2 August 2018).

⁶¹ Ibid.

done].”⁶² To sum up Mark Carney’s views on the impact of Brexit on derivatives: “It’s unfortunate, it’s complicated. I’m not sure when Article 50 was designed if it was with the derivatives market in mind.”⁶³ The contracts problem described by Governor Carney is now being addressed by ESMA (as of 8 November 2018).

Three potential models for EU-UK regulatory arrangements in financial services have been proposed ranging from mutual recognition, enhanced equivalence to equivalence minus. However, it is now likely that the negotiated arrangement to be achieved between EU and the UK will resemble what Lord Hill who served as the European Commissioner for Financial Stability, Financial Services and Capital Markets Union from 2014 to 2016 calls “equivalence minus.”⁶⁴

Figure 2: Financial Services Regulation Plan EU – UK Post Brexit



Politics may play a role when the EC decides to place time limits on an equivalence decision: “The Swiss, for instance, were incensed in December [2017] when the EC decided to renew the licences of Swiss stock exchanges for only 12 months. This had nothing to do with Swiss financial standards and everything to do with the EC’s desire to put pressure on Berne over a quite separate negotiation concerning the role of the Court of Justice of the European Union (CJEU). Equivalence is “not a human right”.⁶⁵ What may be politically acceptable to

⁶² Patrick Hosking, “Brexit: This will hurt you more than it hurts me, Carney warns EU”, The Times, 18 July 2018, available at: <https://www.thetimes.co.uk/article/this-will-hurt-you-more-than-it-hurts-me-carney-warns-eu-dnlbb5rpk> (accessed 23 July 2018).

⁶³ BoE, Financial Stability Report Press Conference, op cit.

⁶⁴ Patrick Jenkins and Caroline Binham, “City of London struggles to unite on post-Brexit regulation: Financiers and ministers divided on rules for sector after UK leaves EU”, FT, 5 July 2018, available at: <https://www.ft.com/content/1d822d24-7f8c-11e8-8e67-1e1a0846c475#comments-anchor> (accessed 8 July 2018).

⁶⁵ Raphael Hogarth, ‘Equivalence’ after Brexit does not suit the City — it could easily become ‘exclusion’, The Times, 10 August 2018, available at: <https://www.thetimes.co.uk/edition/business/equivalence-after-brexit-does-not-suit-the-city-it-could-easily-become-exclusion-txfgxvsqs> (accessed 11 August 2018).

both the EU and the UK and palatable for the UK financial services industry is to accept equivalence as the basis of the relationship post-Brexit along with the fact that the decision of the both the EU and UK to grant and withdraw equivalence is to be an autonomous measure subject to their respective law and courts. Financial services entities operating in the UK have confidence and familiarity with EU institutions and the CJEU. However, for predictability purposes it would help if certain constraints are agreed between the EU and UK as to how and when equivalence can be withdrawal, e.g., time limits and adjustment periods. What remains unsolved or unsolvable is how and where a dispute between the EU and UK on the withdrawal of a particular equivalence decision would be resolved, e.g., before the UK courts, the CJEU or through an arbitration panel independent of both the UK and EU judicial bodies.

As Valdis Dombrovskis, EC Vice President responsible for financial services, stated in a speech in April 2018 that equivalence was a pragmatic solution for the UK after Brexit: "To sum up: equivalence is not perfect, neither for firms nor for supervisors. But one should not make the perfect be the enemy of good. Equivalence has proven to be a pragmatic solution that works in many different circumstances, and it can work for the UK after Brexit as well".⁶⁶ How far the EU is willing to go to make its equivalence rules more "UK friendly" to avoid the possibility that the UK will end up setting itself up as a competing offshore financial hub with little or no EU input into UK regulatory matters remains unclear. "The EU is already talking about how it needs to amend equivalence rules," said Brian Polk, a director at PwC in London. "It is hard to understand why they would not engage with the UK's suggestions. It feels like there is plenty of room to cut a deal."⁶⁷

The Chequers Plan with its vision for a more arm's-length relationship between the EU and the UK has in some ways made the task of agreeing a declaration on the future relations in financial relations to be contained in the Withdrawal Agreement simpler than originally envisioned: "This has gone from being one of the most feared paragraphs [of the declaration] to something that is no longer so daunting to do," said one EU diplomat handling Brexit.⁶⁸ Entering into such a declaration would mark the start of a long negotiation, which could run well beyond the end of Britain's transition in December 2020, rather than a finale in which big concessions are made.⁶⁹

iv) EMIR 2.2

The publication of a general report on EMIR⁷⁰, submitted by the EC to the European Parliament and the European Council in November 2016, concluded that there does not

⁶⁶ Deslandes and Magnus, op cit.

⁶⁷ John Glover, Can the U.K. and EU Cut a Brexit Deal on Financial Services?, Bloomberg, 18 August 2018, available at: <https://www.bloomberg.com/news/articles/2018-08-18/can-the-u-k-and-eu-cut-a-brexit-deal-on-financial-services> (accessed 18 August 2018).

⁶⁸ Alex Barker, "Brexit financial services talks result in rare consensus: Despite Northern Ireland deadlock, issues affecting the City are all but settled", Financial Times, 5 November 2018, available at: <https://www.ft.com/content/3d902998-deb1-11e8-9f04-38d397e6661c> (accessed 8 November 2018).

⁶⁹ Ibid.

⁷⁰ EC, Report from the EC to the European Parliament and the European Council under Article 85(1) of Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives,

seem to be a need for fundamental changes to be made to the nature of the core requirements of EMIR. If changes were needed to ensure transparency and mitigating systemic risks in the derivatives markets such changes should carefully consider the international principles in the derivatives markets field in order to ensure an efficient functioning of global markets. Following on from this study, a new supervisory approach to CCPs was proposed by the EC in June 2017⁷¹ under EMIR 2.2 which would entrust ESMA with the supervision of third country CCPs which are subject to proportionate requirements depending on whether ESMA determines these CCPs to be systemically important or likely to become that (Tier 2 CCPs). Tier 2 CCPs would be subject to “dual supervision” from both ESMA and the third country competent authorities. ESMA would also have full access to information and hold the same regulatory powers for these Tier 2 CCPs as if they were established in the EU.

The risk that the UK “crashes out” of the EU without an agreement for an orderly withdrawal including a transition period is what is driving the move for EMIR 2.2 and the desire for tighter control over third country CCPs. In this case, UK-CCPs’ authorisations as EU-CCPs would expire at the end of March 2019. If an orderly withdrawal is agreed and a transition period to come into place, this would only delay the authorisation of UK-CCPs as EU-CCPs until the end of December 2020. Thus, it becomes critical for the EU to have a functioning supervisory system for systematically important third country CCPs as soon as practicable. Volker Brühl published a study estimating the potential costs associated with relocating Euro-denominated OTC derivatives clearing to the EU.⁷² Brühl notes that ESMA has identified that there are substantial differences in the methods applied by CCPs to determine the IM and the default fund contributions concluding that certain CCPs are more generous than others when it comes to assessing portfolio-margining effects. As such to avoid the possibility of any regulatory arbitrage that might result from this, a considerably greater convergence of supervisory procedures such as that proposed in EMIR 2.2 is recommended.

What follows on below in Figure 3 is the regulatory structure by which ESMA proposes to regulate Tier 2 “Systematically Important” CCPs operating in third countries.

central counterparties and trade repositories (COM/2016/0857 final), available at: <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52016DC0857> (accessed 12 August 2018).

⁷¹ Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Regulation (EU) No 1095/2010 establishing a European Supervisory Authority (European Securities and Markets Authority) and amending Regulation (EU) No 648/2012 as regards the procedures and authorities involved for the authorisation of CCPs and requirements for the recognition of third-country CCPs [COM/2017/0331 final - 2017/0136 (COD)], available at: <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52017PC0331> (accessed 12 August 2018).

⁷² Volker Brühl, “Clearing of euro OTC derivatives post Brexit - an analysis of the present cost estimates”, Center for Financial Studies – No 588, 29 November 2017, available at: https://www.ifk-fcs.de/fileadmin/downloads/publications/wp/2017/CFS_WP_588_EN.pdf (accessed 13 August 2018).

Authorisation of Tier 2 CCPs by ESMA

➤ Tier 2 CCPs willing to service clearing members or trading venues established in the EU would be authorised by, and registered with, ESMA following an authorisation process comparable to that of CCPs established in the EU

ESMA 'Comparable Compliance' Analysis of Tier 2 CCP

Compliance with material rules of EMIR (Article 16 and Titles IV and V of EMIR). ESMA to take into account the extent to which a CCP's compliance with those requirements is satisfied by CCP's compliance with the comparable requirements applicable in the third country.

ESMA Supervisory Powers Over Tier 2 CCPs

CCP gives unconditional written to produce within 72 hours after ESMA request any documents, records, information and data its holds at any time and authorisation that ESMA may access any of CCP's business premises. Independent legal opinion to be provided confirming this consent to be permissible under applicable third country law.

Figure 3: ESMA's Dual Supervision Regime Over Tier 2 CCPs

The Economic and Monetary Affairs Committee (ECON) of the European Parliament [EP] agreed a report on the EMIR 2.2. proposal. Three-way negotiations between the EP, EC and European Council will follow, once Member States (which comprise the EC) agree their position. The plans include setting up a new Supervisory Committee within ESMA for CCPs and require both EU CCPs and the third country ones supplying services in the EU to be subject to more EU-level supervision. Roberto Gualtieri, MEP and ECON Chair, noted that "this is the first case of adoption by the ECON of a reviewed and improved equivalence mechanism which shows how this is the appropriate tool for dealing with third countries in the financial services, and in particular with the consequences of Brexit."⁷³

EMIR 2.2 has its critics, most notably, Chairman Giancarlo of CFTC who has expressed concern with parts of the EU proposal that would subject US CCPs to overlapping EU regulation and supervision without due deference to CFTC regulation and supervision that was already agreed to between the EU and the US in the CFTC-EC Common Approach (2016). Giancarlo's views are that there is no need to alter what is already in place: "The CFTC's requirements for CCPs, like the EU's, are based on agreed upon international principles. Additional regulation is unnecessary and adds to confusion and cost. The arrangement is working now. I hope this issue does not divide the US and Europe.

⁷³ European Parliament, Press Release ECON 16 May 2018, Economic and Monetary MEPs back stricter EU supervision of clearing houses, available at: <http://www.europarl.europa.eu/news/en/press-room/20180516IPR03633/economic-and-monetary-meps-back-stricter-eu-supervision-of-clearing-houses> (accessed 12 August 2018).

Regulatory and supervisory deference is the path upon which the US and Europe should journey together.”⁷⁴

Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, has expressed views similar to those of Chairman Giancarlo. Dombret suggests that the proposed Tier 2 requirements might be appropriate for third country CCPs that operate in countries that do not possess a regulatory culture as pervasive as that which exists in the US; however, they do not make sense for US CCPs that are already heavily regulated in their home jurisdiction.⁷⁵ When Chairman Christopher Giancarlo testified before the US House of Representatives Committee on Agriculture on 25 July 2018 he said he was steadfast in his opposition to revisit the current The CFTC-EC Common Approach (2016). Giancarlo pointed out that imposing EU law obligations on US CCPs operating in the US would be unworkable creating situations where regulatory measures which are critical to US futures markets would be viewed as impermissible under EU law.⁷⁶

Patrick Jenkins writes that if the dispute between the US and the EU over EMIR 2.2 is not resolved the uncertainty and tension that will result in the global market in derivatives trading will affect the efficiency of the system.⁷⁷ When national and multinational regulators cannot agree on a system of collaborative oversight, this results in multiple regulators demanding compliance with different standards sometimes even in the same location: “Markets still operate but the smaller, more fragmented pools of collateral posted to back the swaps will cause pricing spreads to widen, with the net result that companies, pension funds and financial institutions have to pay more to hedge risks.”⁷⁸

v) Euro clearing in London After Brexit

Tom Fairless, writing in The Wall Street Journal, concludes that the next EU-US battleground will be clearinghouses.⁷⁹ He notes that even though the EU has ‘dialled back’ threats to force London clearinghouses to relocate to Europe after Brexit, this shift is unlikely to satisfy US regulators who are very much concerned that EU proposals to increase its control over the clearing of Euro-denominated securities and derivatives would impose new costs and

⁷⁴ CFTC, Speeches & Testimony – Remarks of J. Christopher Giancarlo at the Association of German Banks, Berlin, 7 May 2018, available at: <https://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo45> (accessed 13 August 2018).

⁷⁵ Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, Speech - “How Will Brexit Change The Map of Global Finance?”, 2018 Europe - US Symposium of the Harvard Law School Program on International Financial Systems, Armonk, New York, 11 April 2018, available at: <https://www.bis.org/review/r180419i.pdf> (accessed 13 August 2018).

⁷⁶ CFTC, Speeches & Testimony - Testimony of Chairman J. Christopher Giancarlo before the House Committee on Agriculture, Washington, D.C., 25 July 2018, available at: <https://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo50> (accessed 18 August 2018).

⁷⁷ Patrick Jenkins, “Why we could all pay the price for obscure derivatives rules: An EU-US dispute over financial regulation could determine the price of hedging risk”, Financial Times, 29 October 2018, available at: <https://www.ft.com/content/1846b720-d87a-11e8-a854-33d6f82e62f8#comments-anchor> (accessed 8 November 2018).

⁷⁸ Ibid.

⁷⁹ Tom Fairless, “The Next EU-U.S. Battleground: Clearinghouses”, Wall Street Journal, 1 June 2018, available at: <https://www.wsj.com/articles/regulatory-debate-simmers-over-clearinghouses-after-brex-it-1527859807> (accessed 19 September 2018).

burdens on US clearinghouses with EU customers. Disagreement over the fate of Euro-clearing after Brexit came out into the open at a London derivatives industry conference held in June 2018 when Brian Bussey, the CFTC official responsible for clearing, disagreed with his German Bundesbank counterpart, Jochen Metzger, over who should regulate the Euro-denominated IRS clearing powerhouse, LCH, after Brexit.⁸⁰

LCH regularly clears around €1 trillion-a-day in contracts, representing around three-quarters of the global market of which Euro-denominated contracts make up roughly a quarter of LCH's daily volumes.⁸¹ The agreement currently worked out after the collapse of Lehman Brothers is that this area of LCH's operations are supervised by the BoE and the Banque de France and Bundesbank jointly. In the event of a "no deal" Brexit or even a negotiated settlement, Mr Bussey indicated that the CFTC would be satisfied with the BoE having sole oversight over LCH Euro-denominated IRS clearing; neither possibility is satisfactory for Mr Metzger.⁸²

While the issue of oversight has yet to be resolved, more and more euro-denominated IRS clearing is being on shored to the EU and the Paris unit of LCH will overtake London in repo Euro clearing after Brexit.⁸³ UBS expects London to lose at least 25% of its Euro clearing volumes as a result of Brexit and thinks the losses could be even greater in the event of a disruptive exit from the EU.⁸⁴ London dominates the market for clearing contracts priced in Euros and LCH is by far the biggest venue.

As of 30 October 2018, EC Vice President for financial services Valdis Dombrovskis indicated that relief would be available in the event of a no-deal Brexit which would allow EU banks and companies to continue using UK-based clearing houses to process derivatives trades although this concession would be on a strictly short-term basis.⁸⁵ Such a concession would be linked to the UK's willingness to remain aligned during such a period to EU regulatory and supervisory standards: "Should we need to act, we would only do so to the extent necessary to address financial stability risks arising from an exit without a deal, under strict conditionality and with limited duration," he said.⁸⁶ While the relief proposed by Vice President Dombrovskis is welcome, "it merely pushes the problem into the future as in the absence of a permanent fix banks will still have to decide at some point whether

⁸⁰ Will Hadfield, "Derivatives – Brexit Starting to Loosen London's Grip on Interest-Rate Swaps", Bloomberg, 28 September 2018, available at: https://www.bloomberg.com/news/articles/2018-09-28/brexit-starting-to-loosen-london-s-grip-on-interest-rate-swaps?cmpid=BBBXT092818_BIZ&%E2%80%A6 (accessed 29 September 2018).

⁸¹ Oscar Williams-Grut, "UBS expects London to lose 25% of a €1 trillion-a-day business due to Brexit", Business Insider UK, 14 September 2018, available at: <http://uk.businessinsider.com/brexit-ubs-expects-londons-lch-to-lose-25-of-euro-clearing-volumes-2018-9> (accessed 29 September 2018).

⁸² Hadfield, op cit.

⁸³ Huw Jones, "Paris unit of LCH to overtake London in repo euro clearing after Brexit", Reuters, 22 March 2018, available at: <https://uk.reuters.com/article/uk-britain-eu-clearing/paris-unit-of-lch-to-overtake-london-in-repo-euro-clearing-after-brexit-idUKKBN1GY1WJ> (accessed 29 September 2018).

⁸⁴ Hadfield, op cit.

⁸⁵ Jim Brundsen and Philip Stafford, "EU pledges access to UK clearing houses in no-deal Brexit: Short-term permission reflects Brussels' fears over financial stability of bloc", Financial Times, 30 October 2018, available at: <https://www.ft.com/content/045fc67a-db9f-11e8-9f04-38d397e6661c#comments-anchor> (accessed 8 November 2018).

⁸⁶ Ibid.

to shift thousands of contracts to one of the remaining 27 EU states or to countries that meet EU standards.”⁸⁷

Analysis published on 6 October 2018 by ISDA, the Association of German Banks (Bundesverband deutscher Banken), the Italian Financial Markets Intermediaries Association (Associazione Intermediari Mercati Finanziari – ASSOSIM), the Banking and Payments Federation Ireland, the Danish Securities Dealers Association (Børsmæglerforening Danmark), the Dutch Banking Association (Nederlandse Vereniging van Banken) and the Swedish Securities Dealers Association (Svenska Fondhandlareföreningen) sets out other reasons (apart from the contracts and passporting issues discussed herein) why a 'no deal' scenario has the potential to create a disruptive 'cliff edge' change in the EU regulatory requirements that apply to OTC derivatives business in a way that may adversely affect EU27 or UK firms and their EU27 and UK clients and counterparties.⁸⁸ While it is true that EU law already provides the EU or EU27 national competent authorities [NCAs] powers to take actions that would mitigate the adverse impact of a Disorderly Withdrawal, there is a risk that these actions would only be taken or become effective after the UK has withdrawn from the EU and become a third country creating the risk of a disruptive hiatus (a gap) between the UK ceasing to be a Member State and the mitigating actions taking effect.⁸⁹

c) US – The Trump Administration

On 20 January 2017, the Trump Administration came into office. President Donald J. Trump nominated then Acting Chairman of the CFTC, J. Christopher Giancarlo, to be its Chairman on 14 March 2017.⁹⁰ Mr Giancarlo’s nomination was confirmed by voice vote of the US Senate on 3 August 2017.⁹¹ It has long been Mr Giancarlo’s view that “America’s derivatives markets are struggling, in some cases, under the weight of flawed and excessive regulation....The overly prescriptive regulation of American derivative markets is a part and

⁸⁷ Jim Brundsen, Philip Stafford and Caroline Binham, “Brexit, banks and clearing: dealing with the risks EU gives assurances on clearing houses but many concerns remain”, Financial Times, 31 October 2018, available at: <https://www.ft.com/content/97fcdfe-d3a3-11e8-a9f2-7574db66bcd5> (accessed 8 November 2018).

⁸⁸ ISDA, the Association of German Banks (Bundesverband deutscher Banken), the Italian Financial Markets Intermediaries Association (Associazione Intermediari Mercati Finanziari – ASSOSIM), the Banking and Payments Federation Ireland, the Danish Securities Dealers Association (Børsmæglerforening Danmark), the Dutch Banking Association (Nederlandse Vereniging van Banken) and the Swedish Securities Dealers Association (Svenska Fondhandlareföreningen), “The impact of Brexit on OTC derivatives: Other 'cliff edge' effects under EU law in a 'no deal' scenario”, 6 October 2018, available at: <https://www.isda.org/a/FAvEE/Brexit-Other-Cliff-Edge-Effects-Under-EU-Law-in-a-No-Deal-Scenario.pdf> (accessed 9 November 2018).

⁸⁹ Ibid.

⁹⁰ George Parker, “UK shelves financial services Brexit position paper”, Financial Times, 22 January 2018, available at: <https://www.ft.com/content/783a0840-ff71-11e7-9650-9c0ad2d7c5b5> (accessed 23 January 2018).

City accuses government of leaving it in the dark over negotiating position on trade

<https://www.isda.org/a/FAvEE/Brexit-Other-Cliff-Edge-Effects-Under-EU-Law-in-a-No-Deal-Scenario.pdf>

⁹⁰ The White House, Office of the Press Secretary, “President Donald J. Trump Announces Intent to Nominate Key Administration Posts”, 14 March 2017, available at: <https://www.whitehouse.gov/the-press-office/2017/03/14/president-donald-j-trump-announces-intent-nominate-key-administration> (accessed 1 June 2017).

⁹¹ US Congress, Website – Nominations Status - PN402 — J. Christopher Giancarlo — Commodity Futures Trading Commission, 115th Congress (2017-2018), available at: <https://www.congress.gov/nomination/115th-congress/402> (accessed 5 August 2017).

parcel of the over-regulation of the US economy that thwarts revival of American prosperity.”⁹² Giancarlo has long advocated that the CFTC must operate based on comity, not uniformity, with overseas regulators working off a flexible, outcomes-based approach for cross-border equivalence and substituted compliance.

i) The Giancarlo-Tuckman Swaps White Paper

A 26 April 2018 white paper written by CFTC Chairman J. Christopher Giancarlo and its Chief Economist Bruce Tuckman in their individual capacities [the Giancarlo-Tuckman Swaps White Paper] argues that the four years of US experience that has passed since the initial implementation of swaps reforms by the CFTC provides a significant sample size to study in order to evaluate the effect, recognise success, address flaws, recalibrate imprecision and optimise measures in respect of the CFTC’s roll-out of swaps market reform under Dodd-Frank.⁹³ The Giancarlo-Tuckman Swaps White Paper⁹⁴ examines the CFTC’s implementation of swaps reform from a pro-reform perspective aligned to Congressional intent with an eye towards continuous improvement. The authors propose reforms to areas of CCP clearing, trade reporting, trade execution, swap dealer capital and the end-user exception.

Their paper argues that swaps regulatory reform is designed to achieve broad-based economic growth and revival through achieving the right balance between market durability and systemic risk mitigation, on the one hand, with the need for healthy trading liquidity, on the other hand.⁹⁵ They make the case that financial regulators have a duty to apply the policy prescriptions of their legislators in ways that enhance markets and their underlying vibrancy, diversity and resiliency. This would include the responsibility to review past policy applications continuously to confirm they remain optimised for the purposes intended, anticipating changing market dynamics and the impact of technological innovation. Figure 4 below sets forth the appropriate balance needed in CFTC regulation of swaps in order to achieve broad-based economic growth and revival.

⁹² CFTC, Speeches & Testimony, Remarks of Acting Chairman J. Christopher Giancarlo before the 42nd Annual International Futures Industry Conference in Boca Raton, FL, “CFTC: A New Direction Forward”, 15 March 2017, available at: <http://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo-20> (accessed 4 June 2017).

⁹³ J. Christopher Giancarlo and Bruce Tuckman, Swaps Regulation Version 2.0: An Assessment of the Current Implementation of Reform and Proposals for Next Steps - White Paper, 26 April 2018, available at: https://www.cftc.gov/sites/default/files/2018-04/oce_chairman_swapregversion2whitepaper_042618.pdf (accessed 3 August 2018).

⁹⁴ CFTC Commissioner Rostin Behnam criticised the release of the Giancarlo - Tuckman Swaps White Paper as not being the proper format for the CFTC to start a dialogue with market participants regarding potential rule changes when the notice and comment process for proposed rules under the Administrative Procedure Act is designed for this purpose. See CFTC Speeches & Testimony, Keynote of Commissioner Rostin Behnam at the FIA 40th Annual Law & Compliance Division Conference on the Regulation of Futures, Derivatives and OTC Products, Washington, D.C., “Our Charming Ways”, 3 May 2018, available at: https://www.cftc.gov/PressRoom/SpeechesTestimony/opabehnam5?utm_source=govdelivery (accessed 9 August 2018).

⁹⁵ Giancarlo-Tuckman Swaps White Paper, op cit

Continuous Swaps Regulatory Reform



Figure 4: US Swaps Regulation 2.0
Balance Needed to Achieve Broad-
Based Economic Growth and Revival

ii) The 2018 CFTC Cross-Border Swaps White Paper

On 1 October 2018 the CFTC published a white paper [2018 CFTC Cross-Border Swaps White Paper] that assesses the CFTC’s application of its swaps rules to cross-border activities and make concrete recommendations for improvements.⁹⁶ The 2018 CFTC Cross-Border Swaps White Paper is based on the reform proposals advanced in the Giancarlo-Tuckman Swaps White Paper. Speaking in London at the Guildhall just before the release of the new white paper, Mr Giancarlo borrowed from Shakespeare noting that “we should see the swaps regulatory reform efforts that have taken place up to this point as the stage for what is to come, the next act. The shape of that next act is ultimately in our discharge.”⁹⁷ With this bold statement, will Chairman Giancarlo finally resolve once and for all the remaining differences that impede a unified US and European approach to swaps regulation?

⁹⁶ J. Christopher Giancarlo, Cross-Border Swaps Regulation Version 2.0 - A Risk-Based Approach with Deference to Comparable Non-U.S. Regulation White Paper, 1 October 2018, available at:

https://www.cftc.gov/sites/default/files/2018-10/Whitepaper_CBSR100118.pdf (accessed 6 October 2018).

The 2018 CFTC Cross-Border Swaps White Paper was published in the individual capacity of its author, Chairman Giancarlo, in a manner identical to the way the Giancarlo - Tuckman Swaps White Paper was published. See fn. 81 above on the criticism of this approach.

⁹⁷ CFTC, Speeches & Testimony, Remarks of Chairman J. Christopher Giancarlo to the City Guildhall, London, 4 September 2018, available at: https://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo52#_ftn2 (accessed 11 September 2018).

Chairman Giancarlo took the extraordinary step in his Guildhall speech to apologise to the global swaps industry for the problems created by the current approach of the CFTC with respect to the application of its swaps rules to cross-border activities. Some examples he cited include:

- The fact that the CFTC approach is expressed in “guidance,” rather than formal regulation creates ambiguity;
- On the whole, the CFTC rules are overly-expansive, unduly complex, and operationally impractical;
- The CFTC rules are premised on an incorrect assumption, namely, that every single swap a US person enters into, no matter where and how transacted, has a direct and significant connection with activities in, and effect on, US commerce requiring the imposition of CFTC transaction rules;
- The CFTC rules are conceptually inconsistent in utilising a “US entity” test for swaps activity abroad and a “territorial” test for swaps activity in the US.
- The CFTC relies on a substituted compliance regime that applies a somewhat arbitrary, rule-by-rule comparison of CFTC and non-US rules under which a transaction or entity may be subject to a patchwork of US and non-US regulation.
- The CFTC rules show insufficient deference to non-US regulators that have adopted comparable swaps reforms for their jurisdictions, which is inconsistent with the CFTC’s traditional approach of comity to competent overseas regulation.
- The CFTC fails to distinguish between those swaps reforms that are designed to mitigate cross border systemic risk and those reforms that address particular market and trading practices that are suitable for tailoring to local trading conditions.
- The CFTC has driven global market participants away from transacting with entities subject to CFTC swaps regulation causing fragmentation of what were once global markets into a series of separate liquidity pools that are less resilient to market shocks, thereby increasing systemic risk rather than diminishing.⁹⁸

Chairman Giancarlo took pains to stress that when the current CFTC approach to cross-border swaps activity were adopted in 2013, non-US regulators such as the EU had not developed their own swaps reforms. The problem that resulted is that when these other jurisdictions came “on line” they overreached on their own part in response to the overreaching CFTC approach. For this reason, Chairman Giancarlo repeated his call (originally made in 2014 when he joined the CFTC as a commissioner) for a reset in the EU and CFTC cross-border regulatory relationship along the lines of the intent behind the 2009 G20 principles.

Chairman Giancarlo has identified several key principles that should guide the CFTC’s new approach to the cross-border application of the swaps rules:

- The CFTC should recognize the distinction between swaps reforms intended to mitigate cross border systemic risk and reforms designed to address particular market and trading practices that are suitable for tailoring to jurisdictional trading conditions.

⁹⁸ Ibid.

- The CFTC should pursue multilateralism, not unilateralism, for swaps reforms that are designed to mitigate systemic risk.
- The CFTC shall be a rule maker, not a rule taker, in overseeing US markets – one marketplace, one set of trading rules.
- The CFTC should act with deference towards comparable swaps reform regulation in non-U.S. markets by adopting a flexible, outcomes-based approach for substituted compliance.
- The CFTC should act to encourage adoption of comparable swaps reform regulation in non-US markets that have not yet adopted swaps reform for any significant swaps trading activity.⁹⁹

The 2018 CFTC Cross-Border Swaps White Paper makes a number of concrete recommendations including the following:

- It proposes a two-tier system that separates foreign jurisdictions into those that are “comparable” and those that are “non-comparable”. Comparable jurisdictions will be given greater control over their own regulatory matters so long as such matters do not pose a risk to the US financial system.
- The CFTC should expand the use of its exemptive authority for non-US CCPs that clear swaps and that do not pose substantial risk to the US financial system if the CCPs are subject to comparable, comprehensive supervision and regulation in their home country.
- The CFTC should exempt non-US trading venues subject to comparable regulation from registration as SEFs with respect to all types of swaps (both swaps that are subject to the CFTC’s trade execution requirement and swaps that are not).
- The CFTC should take an approach to registration for non-US swap dealers that both recognises risk-mitigating measures and shows appropriate deference to non-US regulatory regimes that have comparable requirements for entities engaged in swap dealing activity. Non-US persons should not have to count toward their *de minimis* threshold swaps with other non-US persons that are registered as swap dealers. Non-US persons also should not have to count toward their *de minimis* threshold swaps with foreign consolidated subsidiaries.¹⁰⁰

4. Research Context and Methodology

a) Research Context

There has been academic literature on the subject of cross-border application of the OTC derivatives rules. Alexey Artamonov argues that an overly rigid approach to regulation on the part of EU or US regulators that does not allow for effective substituted compliance of each other’s regulatory regimes causes a ‘schizophrenic’ effect resulting in fragmentation

⁹⁹ Giancarlo London Guildhall Speech, op cit.

¹⁰⁰ Ibid.

and dampening liquidity.¹⁰¹ Howell E. Jackson argues that the ‘second-generation’ substituted compliance that the SEC and the CFTC have begun to employ in the past few years to limit the extraterritorial application of certain provisions of the Dodd–Frank Act poses a dilemma between insisting on regulatory safeguards sufficient to address systemic risk while not generating fragmentation and instability.¹⁰² Matthias Lehmann posits that in the struggle to address issues of legal fragmentation and extraterritoriality in global financial regulation it is necessary to recognise that there is no alternative to a collaborative approach, using intensified regulatory dialogue, a broadening of the information base and deference to other states’ rules; this should include the introduction of multinational panels to assess whether regulatory and supervisory set-ups of two or more states lead to comparable outcomes, in which case they must be recognised as being ‘equivalent’ or ‘substituted compliant’.¹⁰³ John Coffee suggests that the solution to extra-territoriality can only be resolved by the major financial nations which have the right incentives to curb systemic risk because they are exposed to it.¹⁰⁴ Coffee sees the assertion of extraterritorial authority (which both the US and EU have done) as an interim stage in the longer-term development of adequate international "soft law" standards that will be necessary to avoid a “tragedy of the commons.”¹⁰⁵

There is widespread concern expressed by the financial services industries that the different regulatory approaches taken by the US and EU/UK in the derivatives area create unnecessary complexity and inconsistent outcomes. While it is generally accepted that US regulators take a rules-based approach to regulation of derivatives that is highly-prescriptive in nature, the EU approach to regulation takes a principles-based approach. Having said this, there is a sense that EU regulators are pushing towards a more rules-based interpretation of MiFID II in certain areas. The trading obligation for derivatives under MiFIR is closely linked to the clearing obligation under EMIR. Once a class of derivatives needs to be centrally cleared under EMIR, ESMA must determine whether these derivatives, or a subset of them, should be mandatorily traded on a venue that is a regulated market, MTF, OTF or an equivalent third-country trading venue. As such, compliance with MiFID II is a pervasive element of operating in the EU derivatives market. Will EMIR 2.2, if enacted, adopt a similar such prescriptive approach for regulating Tier 2 CCPs?

Much progress has been made to overcome the extraterritorial reach of both EU and US regulation in respect of derivatives. However, more coordination has to be had so that the EU and US regulations in the derivatives area are as borderless and seamless as the operationally intertwined markets they supervise. The regulation must move with the reality of the markets in order for it to be a value-added proposition otherwise it becomes a

¹⁰¹ Alexey Artamonov, “Cross-Border Application of the OTC Derivatives Rules: Revisiting the Substituted Compliance Approach”, *Journal of Financial Regulation*, 2015, 1, 206–225, 225 (accessed 9 January 2018).

¹⁰² Howell E. Jackson, “Substituted Compliance: The Emergence, Challenges, and Evolution of a New Regulatory Paradigm”, *Journal of Financial Regulation*, 2015, 1, 169–205, 205 (accessed 9 January 2018).

¹⁰³ Matthias Lehmann, “Legal Fragmentation, Extraterritoriality and Uncertainty in Global Financial Regulation”, *Oxford Journal of Legal Studies*, Vol. 37, No. 2 (2017), pp. 406–434.

¹⁰⁴ John C. Coffee, “Extraterritorial Financial Regulation: Why E.T. Can't Come Home”, (March 25, 2014). European Corporate Governance Institute (ECGI) - Law Working Paper No. 236/2014; Columbia Law and Economics Working Paper No. 459. Available at SSRN: <https://ssrn.com/abstract=2347556> (accessed 16 August 2018).

¹⁰⁵ *Ibid.*

cost burden that impedes markets and becomes a drag on efficiency. This does not suggest that free market economics should dictate regulation. Rather, regulators must re-think their priorities so as to afford greater flexibility to market players from different jurisdictions to operate across jurisdictional boundaries. The end goal of a jurisdiction's regulation is not to impose restrictions on market players or conduct in their own home jurisdiction that harms or deters foreign entrants. Similarly, a regulator in one jurisdiction must not seek to regulate activities, market players or intermediaries in other jurisdictions but rather should work to ensure that its regulation and the regulation of the other jurisdiction conform to the same set of appropriate risk-based outcomes for activities, market players and intermediaries involved so that they can have full-confidence in deferring to the other jurisdiction's rules.

There was a good deal of concern about the lack of even progress towards achieving the OTC derivatives reform agenda of the G20 countries. In particular, questions were raised about the inconsistency of rules and the potential migration of trading to less regulated jurisdictions as costs rose in important centres.¹⁰⁶ For instance, Chris Brummer suggested in 2013 that US and EU differences regarding reporting obligations could generate uncertainties for end-users as well as differences in compliance costs between jurisdictions, encouraging regulatory arbitrage or prompting end-users to direct trading through subsidiaries.¹⁰⁷

As of June 2017, regulators throughout the world have made significant progress in the implementation of the agreed upon 2009 G20 commitments most notably:

- Trade Reporting – 19 out of 24 FSB jurisdictions have comprehensive trade reporting requirements in force providing insight into global trading activities of multi-national financial institutions;
- Central Clearing – Seventeen FSB jurisdictions have in force comprehensive standards for determining when standardised OTC derivatives should be centrally cleared;
- Margin Requirements for Non-Centrally Cleared Derivatives – 14 jurisdictions now have in place comprehensive margin requirements for non-centrally cleared derivatives; and
- Capital Requirements for Non-Centrally Cleared Derivatives – 23 jurisdictions have put in force higher capital requirements for exposures to non-centrally cleared derivatives consistent with the BCBS bank capital framework.¹⁰⁸

The statistics outlined above suggest that the window of opportunity to arbitrage between different jurisdictions to take advantage of differing standards of regulation amongst

¹⁰⁶ Stijn Claessens and Laura Kodres, International Monetary Fund [IMF] Working Paper WP/14/46: The Regulatory Responses to the Global Financial Crisis: Some Uncomfortable Question, March 2014, available at: <https://www.imf.org/external/pubs/ft/wp/2014/wp1446.pdf> (accessed 3 January 2017).

¹⁰⁷ Dr Chris Brummer, Atlantic Council, TheCityUK and Thomson Reuters, The Danger of Divergence: Transatlantic Financial Reform & the G20 Agenda, 22, available at: http://www.atlanticcouncil.org/images/publications/Danger_of_Divergence_Transatlantic_Financial_Reform_1-22.pdf (accessed 3 January 2017).

¹⁰⁸ Giancarlo London Guidhall Speech, op cit.

significant swaps jurisdiction has largely been eliminated as more jurisdictions implement the 2009 G20 commitments.

b) Methodology

The interest in researching the similarities and differences between regulatory reform on the two sides of the Atlantic stems from the researcher's own expertise with both the legal systems of the US and EU/UK as a lawyer, solicitor and legal academic. The research undertaken was largely reliant on public domain materials as there was reluctance on the part of employees of regulated entities or the regulators themselves (who were involved in ongoing negotiations) to share insights on the record. Having noted these obstacles, public statements made by the involved regulators, trade associations, published research, regulatory decision-making and journalist commentary provided sufficient materials upon which to base the analysis here. These materials include testimony and speeches given by regulators, senior executives and trade association figures which have been particularly helpful, e.g., Michel Barnier, J. Christopher Giancarlo, Lord Hill, Steven Maijoor, Timothy Massad, Scott O'Malia, etc. Several individuals with close first-hand knowledge of the issues and personalities discussed herein have shared their insights subject to the Chatham House Rule whereby information disclosed may be reported but the source of that information may not be explicitly or implicitly identified.

As a legal academic, the researcher's skills lie largely with following a doctrinal approach that tries to ascertain in certain situations 'what is the law?' Such a methodology is interpretive in nature emphasising a qualitative research structure which is to try to understand the meaning and sequence of events and actions involved with the regulatory impasse in the derivatives field between the US and EU that characterised events in the period between 2013 and 2018. What is the context and driving factors that led to such an impasse and how have they been resolved? Has the resolution worked?

While the CFTC was able to draw on its own extensive institutional legacy as an inspiration as to how it should advance its regulatory objectives on the world stage, EU decision-making by contrast tended to be hampered by the fact that the regulators themselves, e.g., ESMA, were new in their function having been established only in 2011 and were still having relational issues to work out with other EU institutions and Member State regulators before they could address the derivatives issues "head-on" (therefore time and momentum were lost).

As ESMA's role is to coordinate rules for the EU with the supervision of financial markets being done at Member State level by national regulators, consistency across the EU is paramount for uniform capital markets operations. ESMA achieves this by providing technical guidance on the MiFID II rules in the form of regulations that have to be applied by each Member State individually. This enhances ESMA's influence across the EU because each Member State's regulatory framework has grafted into its structural DNA the regulation designed by ESMA. However, the proposed EMIR 2.2 reforms may upset this delicate balance that has been reached under the leadership of Steven Maijoor.

People compared the EU's incremental approach to regulation (dealing with reforms in separate legislative proposals) with the US model where regulatory reform of the financial sector was implemented through the "supersized" Dodd-Frank Act, making the argument that the EU legislation will be easier to correct than Dodd-Frank.¹⁰⁹ On the other hand, in the US there is more delegation to the agencies, whereas in the EU more detail was contained in the legislation itself.

With ESMA never having been operational as a regulator before tackling derivatives regulation, the CFTC had a significant advantage in 40 years of actual experience that it was keen to use to its advantage. There was never a question that the CFTC would wait until ESMA got up to speed on the complexities involved in regulating derivatives. This was especially so given that the CFTC was directly answerable to an irate Congress (still smarting from "too big to fail" and the bank bailouts), whereas ESMA was a "greenfields" regulator with "no baggage" left over from the Financial Crisis.

5. Research Findings and Discussion

a) Research Findings

i) Question One

Are the differences between US and EU/UK approaches to derivatives regulation significant in nature or rather do they basically achieve the same result? How might these approaches be affected by Brexit in the UK or the Trump Administration in the US?

When this research project was commissioned in Spring 2013, the differences between US and EU/UK were significant in nature. At this point, in 2018, it can be said that, for the most part, the regulatory approaches achieve basically the same result. The irrationality of the "lost years" - 2013 to 2016 - was not missed on CFTC Chairman Giancarlo who wryly commented on the transatlantic spat:

Compounding the institutional unilateralism, the equivalence determination process was made more complex because both the EC and CFTC essentially held each other's regulatory text up to the ceiling light to determine if the words and font sizes were identical. This line-by-line rule analysis is contrary to the OTC Derivatives Regulators Group [ODRG] approach, which states that a flexible, outcomes-based approach, based on a broad category-by-category analysis, should form the basis of equivalence or substituted compliance.¹¹⁰

The long-term effect that Brexit may have on the regulation of derivatives will depend on the new post-Brexit relationship that the UK and the EU agree upon. In terms of the immediate horizon, it is essential that the smooth functioning of the international derivatives trading market and the critical role that London plays in this as the global centre

¹⁰⁹ HL, EU Committee, 5th Report of Session 2014-15, "The post-crisis EU financial regulatory framework: do the pieces fit?" HL Paper 103 (Ordered to printed 27 January 2015 and published 2 February 2015), 69, ¶196.

¹¹⁰ Giancarlo, op cit.

for Euro denominated clearing must continue without regard to whether a political agreement can be reached on the withdrawal of the UK from the EU. Financial markets regulators and the institutions that they regulate must plan for the worst (a “crash-out” scenario) and a hope for the best (a sensible transition window).

In the medium term, a discussion as to the post-Brexit role that the City of London should play in respect of Euro denominated clearing and the services the City performs for EU clearing members and trading venues needs to be had to give the EU the assurance it requires to have oversight over CCPs operating in third countries (such as the UK) that perform systematically important functions for EU clearing members and trading venues.

If the Trump Administration can reform current CFTC regulation to reduce the extraterritorial impact that current US swaps trading rules have on non-US market participants this could be beneficial to reduce the fragmentation that is occurring in the global swaps trading pool. It is encouraging to see Chairman Giancarlo propose implementing a two-tier system that would separate foreign jurisdictions into those that are “comparable” and those that are “non-comparable” in order to afford comparable jurisdictions greater control over their own regulatory matters so long as such matters do not pose a risk to the US financial system. However, such a reform will require Congress to act and they will look to what the EU is doing in respect of EMIR 2.2 before committing the CFTC to reducing the control it asserts on non-US market participants.

The research concludes that the role of ESMA and its plans to introduce EMIR 2.2 at this juncture will play a pivotal role in determining whether the possibility of further reducing the extraterritorial application of derivatives regulation globally will continue. If the EU enacts proportional and sensible oversight of systematically important third country CCPs, the momentum towards reduction of extraterritorial application of derivatives regulation will progress with further steps being made in this direction by the US. This would in all likelihood lead to a reduction in extraterritorial oversight across all major swaps jurisdictions.

Alternatively, there is the likelihood that progress could halt and could we find ourselves in a “going back to the future” moment recycling something from the past (extraterritorial overreach in derivatives regulation) and packaging it as if it were something new (necessary to ensure post-Brexit continued access to UK CCPs for EU clearing members and trading venues while allowing systemically important CCPs (Tier 2 CCPs) and non- systemically important CCPs (Tier 1 CCPs) from third countries to provide services in the EU). Only time will tell.

ii) Question Two

Is there the potential for banks to manipulate the system by taking advantage of looser regulation in some jurisdictions to avoid more stringent regimes elsewhere? For example, are there instances where a US entity might use the UK as a jurisdiction to remove some of their swap transactions off the CFTC and the SEC regulatory table?

It is undeniable that regulatory arbitrage has risen to the highest levels of concern in the minds of regulators and policy makers worldwide. A financial institution would, therefore, be short-sighted to invest significant resources to engage in regulatory arbitrage and incur heightened scrutiny of its cross-border derivatives activities from EU and US regulators, as well as those in other jurisdictions.

The research findings confirm the view that the greater harmonisation is achieved between the US and the EU/UK regulatory regimes the less likely regulatory arbitrage between the two jurisdictions will take place.

b) Discussion

Discussion Point #1

The cross-border nature of derivatives transactions necessitates national and multilateral regulators to reflect carefully on how their own regulations impact other jurisdictions and the conduct of entities that operate these other jurisdictions.

In terms of cross-border derivatives transactions, it is important to ensure that there is confidence that things being done in one jurisdiction meet similar objectives in another jurisdiction even if not in exactly the same way. When dealing with significant cross-border financial transactions, regulators must consider *ex ante* that any regulation they impose in their own jurisdiction will have to square with the regulatory structure of other relevant jurisdictions. While the fit need not be perfect, it does need to be substantially compatible.

Peter Knaack suggests that three issues explain the lack of coordination between jurisdictions. First, EU and US authorities are wary of the expected distributional consequences¹¹¹ of cross-border harmonisation of OTC derivatives regulation. Second, legislators and pre-existing legislation represent obstacles to cross-border cooperation. Third, the government networks in the EU and US that are expected to overcome these obstacles not only lack authority but are incomplete and weak due to fragmented domestic regulatory systems. Knaack concludes that, for true cross-border regulatory harmonisation to occur, government networks in both the EU and US must be isolated from parliamentary interference and the regulatory form to be followed in each individual must follow function as opposed to being distorted by political concerns.

A shortcoming is that regulators generally work along nation-state lines and that multilateral agencies such as the EC or ESMA are dependent on individual Member State regulators to enforce regulation at the national level. In such circumstances, there may be conflict between what the multilateral agency sees as mission critical and that of the national regulator who may be reluctant to implement a multilateral agenda. This problem crystallises itself in that national legislatures may be reluctant or unwilling to pass legislation

¹¹¹ While Knaack does not elaborate on what he means by the term “distributional consequences” of cross-border regulatory harmonisation it may be inferred that regulators in either the US or the EU would have concerns if such harmonisation results in net losses in terms of income generated from derivative trading activities in their respective jurisdictions.

that necessitate them ceding domestic control over wide swathes of commercial markets to multilateral agendas. Similarly, legal enforcement remains jurisdictionally circumscribed in that national governments are usually capable of enforcing their laws only within the physical boundaries of their national borders. This fragmentation is inherently problematic to the smooth operation of cross-border regulation in the derivatives field.

Compounding the issue of cross-border fragmentation is the issue of extraterritoriality. Annelise Riles provides the example of a derivatives transaction between a Japanese and a British bank, posted to their subsidiaries in the Cayman Islands and involving a swap between Chinese yuan and Singaporean dollars. Two difficult questions emerge – first, in which jurisdiction does this trade take place and, second, whose law applies? As Knaack states “lawmakers both in Europe and the US have found an answer to this question: theirs and only theirs... irrespective of location when the trade has a ‘direct, substantial, and foreseeable effect’ on the jurisdiction.”¹¹²

Regulatory arbitrage is “the process by which financial institutions avoid or minimise regulatory restriction by engaging in a transaction with identical commercial effect but more favourable regulatory treatment.”¹¹³ When considering the issue of regulatory arbitrage, one must bear in mind that it has significant implications for competition among jurisdictions. In such a case, it is the public in the country whose regulation is avoided that is harmed by such conduct. The issue of transatlantic extraterritoriality – how a country such as the US or a group of Member States acting through the EU may exercise legal power beyond its physical borders¹¹⁴ - has been an issue of concern to the financial services industry as it increasingly sees cases of criminal prosecution of foreigners by jurisdictions for crimes committed outside of their respective physical territories.¹¹⁵ There are three elements to extraterritoriality jurisdiction: *prescriptive jurisdiction* which refers to the capacity of a state to legislate in respect of persons or conduct¹¹⁶; *enforcement jurisdiction* which refers to the capacity of a state to enforce compliance with those laws; and *adjudicative jurisdiction* which refers to the ability of courts to adjudicate and resolve disputes concerning matters arising outside of their physical boundaries.¹¹⁷

¹¹² Knaack, op cit.

¹¹³ John Kay, “Other People’s Money: Masters of the Universe or Servants of the People”, Profile Books, 2015, p. 123.

¹¹⁴ See Anthony J. Colangelo, “Essay: What is Extraterritorial Jurisdiction?”, 99 Cornell L. Rev. 1303, 1303 (2014),

<http://cornelllawreview.org/files/2014/09/Colangelo99CLR1303.pdf>, accessed 7 January 2016.

¹¹⁵ James Quinn, “NatWest Three’s David Birmingham tells flash crash trader: Don’t fight extradition”, The Daily Telegraph, 23 April 2015, available at:

<http://www.telegraph.co.uk/finance/financial-crime/11555036/NatWest-Threes-David-Birmingham-tells-flash-crash-trader-Dont-fight-extradition.html> (accessed 7 January 2016).

¹¹⁶ See GE/Honeywell (General Electric/Honeywell, Case No COMP/M. 2220 [2004] OJ L48/1) (EU competition law prohibiting the merger of two US based companies because of effects in the European market); Morrison v. Nat’l Austl. Bank Ltd., 130 S. Ct. 2869, 2881 (2010) (the so-called “triple-cubed” case on whether Australian investors could sue in the US over shares traded on an Australian stock market).

¹¹⁷ Danielle Ireland-Piper, “Prosecutions of Extraterritorial Criminal Conduct and the Abuse of Rights Doctrine”, Utrecht Law Review, Volume 9, Issue 4 (September) 2013, URN: NBN:NL:UI:10-1-112946, available at: <https://www.utrechtlawreview.org/> (accessed 7 January 2016).

The IOSCO Task Force on Cross-Border Regulation, Final Report (Sep. 2015) (IOSCO Report), sets out the precise dilemma regulators face in the context of dealing with the extraterritorial impact of their actions:

Specifically, the process of applying national regulations to businesses operating and transacting on a cross-border basis is not just a function of regulators being bound by national laws to consider how market activities beyond their borders could impact their own domestic markets. Rather, the extent to which domestic financial institutions operate across multiple foreign jurisdictions also appears to be a significant driver of the degree to which the laws and regulations of a home jurisdiction interact with those of a foreign, or host, jurisdiction. This means that the laws and regulations of the home jurisdiction may also apply to the activities of a domestic financial institution and its clients, customers, or counterparties taking place in the foreign jurisdiction, in addition to the laws and regulations of the foreign jurisdiction itself.¹¹⁸

As the IOSCO Report suggests, extraterritoriality necessitates that national regulators consider that when they develop regulations for their own jurisdiction that these regulations may have profound effects in other jurisdictions due to geofinance concerns. As such, a matrix model of regulatory management is required whereby regulators use a solid line to oversee regulated entities in their own jurisdiction but coordinate through a “dotted line” reporting structure with other national regulators when dealing with cross-border financial markets or sophisticated market participants that operate in more than one national jurisdiction.

The impact of the differences between, and duplication of, regulation that applies to cross-border financial activity is a matter of serious concern to the financial services industry involved with US and EU OTC derivatives. When one examines the newfound co-operation that has been achieved between the US and EU regulators, two issues need further examination:

- Consideration must be given to how domestic regulatory regimes apply to global financial markets and interact with other regulatory regimes as well as with international standards.
- Attention must be paid to how regulated entities operating in the different markets interact with various regulatory schemes to maximise competitive advantage whilst ensuring appropriate compliance.

From the perspective of the regulator, a question arises, namely, how does one ensure that potential solutions do not weaken the effectiveness of domestic regulation while, at the same time, not unduly constrain the cross-border offering of financial services or products? The answer to this question is not a simple one and there are trade-offs to be made with each solution. In dealing with cross border regulatory problems, the IOSCO Report identified possible solutions: *first, national treatment; second, recognition; and, third, passporting.*

¹¹⁸ IOSCO Task Force on Cross-Border Regulation, Final Report, FR23/2015, September 2015, available at: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD507.pdf> (accessed 3 May 2016).

The concept of *national treatment* is one in which the domestic regulator generally treats foreign persons, entities and products in the same manner as domestic ones in terms of market access and ongoing requirements, regardless of the foreign regulatory regime. *Recognition* enables the domestic regulator to permit activities of persons and entities, including distribution of products, from recognised foreign jurisdictions to take place within the domestic jurisdiction - unilateral or multilateral recognition. *Passporting* permits market access between the jurisdictions covered by the passporting arrangement based on a common set of rules. A single authorisation or registration allows for the provision of services and products throughout the participating jurisdiction under the supervision of a single home authority.

Discussion Point #2

Recognition of foreign frameworks through deference such as equivalence provisions and determinations are critical for effective working of international derivatives market in the post Financial Crisis environment.

The solution reached by the EC and CFTC is along the lines of *recognition*, namely, *equivalence*. The EC has determined that the CFTC has the equivalent requirements as the EU in regulating CCPs and the CFTC have determined now that the EC has the equivalent requirements as the CFTC in regulating CCPs. Under the *recognition* approach, the regulator recognises the foreign regulatory regime in substitution for its own if the regulator finds that the other regulatory regime provides a sufficient basis for a finding of comparability with respect to applicable regulatory obligations.

Recognition – such as *equivalence* – alleviates regulatory conflict by allowing compliance with only one set of rules. This requires to a certain extent a high level of trust in that one national or multilateral regulator (in the case of the EC) is relying on the effectiveness of the other regulator for effective oversight of their own regulatory regime considering formal requirements promulgated into regulation and best practice that accompanies it as well and these are enforced and administered. Moreover, the concept of *equivalence* requires cooperative approaches and mechanisms to ensure pathways to resolve differences and to assess comparative approaches to problems. *Equivalence* is an outcomes-based approach granted not to individual entities but to countries. This, however, does not mean that one country's regulations must reproduce word-for-word the regulations of another country – the emphasis here is that one country's regulations should in the end achieve the same objectives.

Lehmann adds a bit more depth to the concept of deference whether it is the US *substituted compliance* or the EU *equivalence*. Although the different names reflect divergent approaches, they both necessitate the recognition of foreign regimes which will be of no use if the conditions precedent are applied so stringently that the regulator only accepts rules that are identical to its own.¹¹⁹ This requires a national or supranational regulator to adopt a “cosmopolitan perspective” to view a foreign regulation as being an ‘equivalent’ to its own. This nuanced approach - a recognition of regulatory diversity – means that an agency

¹¹⁹ Matthias Lehmann, “Legal Fragmentation, Extraterritoriality and Uncertainty in Global Financial Regulation”, *Oxford Journal of Legal Studies*, Vol. 37, No. 2 (2017), pp. 406–434, 425.

following an equivalence must be sophisticated enough to “not interpret any variance of a foreign regime as a sly attempt by the other state to undercut strict standards in order to improve its position in global regulatory competition.”¹²⁰ Rather, it should be done out of mutual respect that the divergence is based on a different tradition, experience or knowledge of the particular country.

Discussion Point #3

National or multilateral regulators need to “think globally, act locally” to avoid developing legislation that operates in an extraterritorial manner which when combined with the extraterritorial effects of third country legislation prove damaging to markets.

More specifically, regulators must limit the damaging effects of divergence, either by consultation with international counterparts in preparation of legislation, or by resolving these differences during implementation of legislation. There has been universal concern that Dodd-Frank and the rules adopted by the US regulators to implement the same go too far beyond the G20 agreed upon international commitments to overreach. Dodd-Frank gives the CFTC and SEC significant tools to assert broad extraterritorial powers to regulate the swap trading activities outside of the US of non-US persons. Griffith characterises the US position as pursuing regulatory uniformity through harmonisation, on the one hand, but, failing that to fall back on a regulatory mode closer to imposition of rule by fiat through the extraterritorial application of US law.¹²¹

Here, however, the US was not the only one to blame according to Coffee who notes that although the US has received considerable criticism for its expressly extraterritorial approach, the EU did precisely the same.¹²² The concern for the US was that without the broad extraterritorial reach, those involved with OTC derivatives could do these high-risk transactions outside the US and flout the Dodd-Frank reforms. Similarly, Coffee states that “in respect of the EU, there was an equivalent concern that the US approach ignored national sovereignty and represented an alleged return to a prior tradition of US imperialism under which the US assumed that its preferred financial practices could be mandated for the rest of the world.”¹²³

Discussion Point #4

The critical issue now is market fragmentation, which is something that the derivatives industry on both sides of the Atlantic are engaged in a quick catch-up to fix.

Fragmentation refers to the possibility that, rather than integrating and continuing the current path of globalisation, national economies will retreat behind their borders. Although now [2018] there is clear alignment from the US and EU regulators with respect to implementing the broad G20 mandate on derivatives reform, an unintended consequence

¹²⁰ Ibid.

¹²¹ Griffith, op cit., 1337.

¹²² John C. Coffee, Jr., Extraterritorial Financial Regulation: Why E.T. Can't Go Home, 99 Cornell L. Rev. 1259, 1263, 2013-2014.

¹²³ Ibid at 1264.

of the disjointed approach to regulation has exacerbated the fragmentation of the transatlantic derivatives market. The fragmentation must be resolved before an irretrievable schism develops. We are still some way from saying that regulatory efforts on both sides of the Atlantic are fully coordinated and operate in such a way as to facilitate a transparent and seamlessly functioning derivatives market in which systemic risk and possibility of financial contagion are significantly diminished.

An FSB study [2017]¹²⁴ into the effectiveness of the OTC derivatives reforms introduced after the Financial Crisis [2008] noted that both regulatory arbitrage and market fragmentation can result where there is uneven implementation, different timing of the reforms, or a lack of coordination (e.g. with respect to clearing or trading mandates) among peer jurisdictions. As such there is a pronounced premium on ensuring consistency between jurisdiction in determining the scope and timing of the development of clearing frameworks, the imposition of mandatory central clearing requirements, the timing of the development of platform trading frameworks and the imposition of platform trading requirements. For instance, evidence supports the theory that differences in the timing of mandatory trading requirements in the US and EU led to market fragmentation in the non-USD-denominated segments of the IRS market.¹²⁵ However, a BoE working paper (2016) authored by Benos et al. concluded that this fragmentation has not negatively affected market liquidity.¹²⁶

Discussion Point #5

The policymaking process with respect to OTC derivatives would have been better served had the CFTC avoided the politicisation of the cross-border regulatory rulemaking and instead focused on finding technical solutions to the problems involved.

Having become a focal point of the G20's agenda for financial reform, CCPs became the globally mandated means of addressing the systemic risk of derivatives transactions. As such, this should have been priority number one for the CFTC to implement without delay. Martin Wheatley, the Financial Conduct Authority (FCA) Chief Executive from 1 April 2013 until 12 September 2015, voiced his frustration with the US regulatory grab: "Does it make hard-nosed, practical sense for any one national regulator to attempt to regulate all derivatives activity with any link to its jurisdiction? The clear risk is that a patchwork quilt of national and regional rules runs the risk of becoming unworkable. A mess."¹²⁷ In simplest terms, the question came to be whether under the CFTC rules, a derivatives trading

¹²⁴ FSB, Review of OTC derivatives market: Effectiveness and broader efforts of the reforms, 29 June 2017, 37 - 39, available at: <http://www.fsb.org/wp-content/uploads/P290617-1.pdf> (accessed 30 September 2018).

¹²⁵ Ibid.

¹²⁶ BoE, Evangelos Benos, Richard Payne and Michalis Vasios, Staff Working Paper No. 580 Centralized trading, transparency and interest rate swap market liquidity: evidence from the implementation of the Dodd-Frank Act, July 2016, available at: <http://www.bankofengland.co.uk/research/Documents/workingpapers/2016/swp580.pdf> (accessed 9 August 2017)

¹²⁷ Tom Braithwaite, Michael Mackenzie, Alex Barker, Philip Stafford and Gina Chon, "US rules 'endanger' derivatives reforms", Financial Times, 26 September 2013, available at: <https://next.ft.com/content/dda5f480-26c4-11e3-bbeb-00144feab7de> (accessed 19 May 2016).

platform – whether based in London, Singapore or Zurich – must register and follow the US rule book if it trades with a US counterparty.¹²⁸

Discussion Point #6

When organisations engage in regulatory arbitrage their behaviour must be seen as utilitarian in nature highlighting the deficiencies in cross-border regulatory environments. In response, regulators should focus on eliminating the lacuna that gave rise to the regulatory arbitrage as opposed to penalising the organisation for acting in a way that is within their legal right to do so.

Christian Johnson suggests that the US is committed to eliminating regulatory arbitrage through extraterritorial action as opposed to harmonisation and cooperation. He notes that “to the extent that the global swap dealers do business in the US, the CFTC can use the extraterritorial powers given to them under Dodd-Frank to curtail regulatory arbitrage and create a regulatory floor for global OTC derivative regulation.”¹²⁹

However, for Larry Thompson, DTCC Managing Director and General Counsel, the only way to get rid of regulatory arbitrage is through harmonisation:

The major sticking point is that, unlike the securities markets, derivatives have no set domicile – these markets and their participants are global and incredibly diverse. As a result, if new OTC derivatives frameworks are not implemented consistently across jurisdictions, regulatory gaps could develop, leaving the door open for regulatory arbitrage. So, it is important to both supervisors and market participants that rules be developed and applied uniformly across jurisdictions to ensure proper supervision, transparency and continued competition in the derivatives space.¹³⁰

While the focus here has been transatlantic regulatory arbitrage, Zohar Hod, head of sales and support at SuperDerivatives, notes that “the bigger story in the global arbitrage saga is undoubtedly Asia. The geographical and regulatory patchwork of this region is so vast and so varied and often so unaligned with US and European efforts – that the opportunities for arbitrage are endless.”¹³¹ Anne Plested, head of regulation change programme at Fidessa Group plc, however, suggests that in terms of transatlantic regulatory arbitrage “the world’s

¹²⁸ For more on this, see Tom Braithwaite and Michael Mackenzie, “Question on the derivatives debacle: A brief explanation on the debate between CFTC and the world”, Financial Times, 26 September 2013, available at: <https://next.ft.com/content/31ee17dc-26e5-11e3-9dc0-00144feab7de> (accessed 20 May 2016).

¹²⁹ Johnson, op cit. Research by David Mengle, ISDA Head of Research, as of 2010 indicates that US based derivatives dealers account for 37 percent of the global total notional amount outstanding of derivatives. See David Mengle, “Concentration of OTC Derivatives among Major Dealers”, ISDA Research Notes, Issue 4, 2010 available at: http://www.isda.org/researchnotes/pdf/ConcentrationRN_4-10.pdf (accessed 9 January 2016).

¹³⁰ Roland Kielman, “Thought Leadership: Why Regulatory Harmonisation Across Borders Matters”, DTCC Connection, 1 October 2012, available at: <http://www.dtcc.com/news/2012/october/01/thought-leadership-why-regulatory-harmonisation-across-borders-matters.aspx> (accessed 8 January 2016).

¹³¹ Futures & Options World, “The regulatory arbitrage debate: How great is the threat of regulatory arbitrage between US, Europe and Asia?”, 28 May 2014, available at: <http://www.fow.com/3346159/Reader-Reaction.html> (accessed 9 January 2016).

regulators are increasingly seeking to exchange information on their respective experiences, at both global and regional levels, in order to help develop the markets, strengthen market infrastructure and implement appropriate regulation. Assuming these efforts succeed, the threat of regulatory arbitrage is considerably less than it once was.”¹³²

John Nicholas, Global Head of New Regulation Monitoring and Implementation, Newedge, suggests:

Regulatory arbitrage opportunities do not always result in a race to the bottom. Many financial intermediaries and their clients prefer a more robust regulatory structure. Moreover, it should be noted that while the current prevailing view that a result-driven approach to mutual recognition – where one jurisdiction accepts another’s regulatory structure notwithstanding material differences between their respective rulebooks – will facilitate cross-border trading on a more expedited basis, it will also present regulatory arbitrage opportunities in the long run. This is a trade-off that regulators must understand.¹³³

Regulators must also leave sufficient room for the industry to use regulatory arbitrage as a tool to innovate in the development of new financial products. For instance, it can encourage the industry to modify the design of centrally cleared products so that they can remain as such while at the same time avoiding costs related to heightened regulatory scrutiny. This sort of intra-jurisdiction regulatory arbitrage can be seen in the US where the industry is restructuring its products to fit more efficiently into US margin requirements.

Carmela D’Avino suggests that the US regulatory framework for regulation of OTC derivatives sets forth an extraterritorial applicability to foreign transactions involving US financial institutions which allows foreign branches of US banks to comply with local regulation via a substitute compliance framework in a number of jurisdictions with broadly comparable provisions.¹³⁴ Her research found that in focusing on IRS that substituted compliance has resulted in regulatory arbitrage by foreign branches of US banks tilting the playing field in favour of those countries in which the framework is available.¹³⁵ Lagged implementation timing and/or marginally less stringent regulation in those jurisdictions where substitute compliance is available may indeed cause an increase in geographical concentration of swaps trading in favour of these latter.¹³⁶

Discussion Point #7

At the heart of reducing opportunities for regulatory arbitrage is greater international coordination and cooperation.

¹³² Ibid.

¹³³ Ibid.

¹³⁴ Carmela D’Avino, “Banking regulation and the changing geography of off-balance sheet Activities”, *Economics Letters* 157 (2017), 155-158, available at: <http://www.sciencedirect.com/science/article/pii/S0165176517302215?via%3Dihub> (accessed 10 January 2018).

¹³⁵ Ibid.

¹³⁶ Ibid.

Since the transatlantic impasse was identified in 2013, there has been an undeniable trend amongst various national and multilateral regulators to “fend off” regulatory arbitrage opportunities. Regulators can point to accomplishments in various areas such as the harmonisation of margin rules, the clearinghouse equivalence accord reached between the US and EU, the coordination of swap clearing mandates, clearinghouse resilience efforts and the work on swap reporting standardisation.¹³⁷

At the same time, the battle to prevent regulatory arbitrage suggests that further work must be done beyond the US and the EU to engage other jurisdictions including Australia, Canada, China, Hong Kong, India, Japan, Mexico, Singapore and other jurisdictions. Former CFTC Chairman Massad in his final remarks as CFTC Chairman warned that the hard lessons learned from AIG show that international cooperation in the regulation of the global financial marketplace is essential because the global financial marketplace has outstripped the ability of national regulators to oversee it.¹³⁸ Addressing the Trump Administration’s argument for a more robust ‘economic nationalism’ at the expense of multilateralism, Mr Massad argued that “to pull back from such cooperation would be to send us toward a path of regulatory inconsistency, or even competition, that can only be destructive.”¹³⁹

Discussion Point #8

Greater comity would also work to reduce the possibility of regulatory arbitrage.

Chairman Giancarlo sees cross-border rule harmonisation as essential to reforming the swaps markets but he emphasizes the need to define “limits on the cross-border application of US swaps rules in a way that invites international comity, rather than demands international uniformity.”¹⁴⁰ While bemoaning the lack of consistent cross-border cooperation between the CFTC and foreign regulators, Mr Giancarlo faulted the CFTC for starting the rift with the CFTC Interpretative Guidance that many EU regulators saw as a US betrayal of the earlier agreed “Path Forward.”¹⁴¹ Mr Giancarlo sets forth what could be characterised as his comity doctrine:

I generally believe the best route to regulating the trading of swaps in global markets is thoughtful deference to fellow G20 regulators within the Pittsburgh Summit’s goal of rule consistency. Regulators must set limits on the cross-border application of swaps rules to achieve the ends of market reform in a spirit of cooperation and deference. And, regulators must follow the flexible,

¹³⁷ CFTC, Speeches & Testimony, Keynote Remarks of Chairman Timothy Massad at SEFCO VII, 18 January 2017, available at: <http://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-55> (accessed 26 February 2017).

¹³⁸ Ibid quoting Giancarlo: “[Cross-border harmonization] means no longer asking U.S. market participants to go it alone and take it on the chin in implementing global regulatory reform as too often has been done.”

¹³⁹ Ibid.

¹⁴⁰ CFTC, Speeches & Testimony, Keynote Remarks of Commissioner Christopher J. Giancarlo at SEFCO VII, 18 January 2017, available at: <http://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo-19> (accessed 26 February 2017).

¹⁴¹ Ibid. See also EC, EC Memo, The EC and CFTC Reach a Common Path Forward on Derivatives, 11 July 2013, available at: [http://europa.eu/rapid/press-release MEMO-13-682_en.htm?locale=en](http://europa.eu/rapid/press-release_MEMO-13-682_en.htm?locale=en) (accessed 21 August 2013).

outcomes-based approach advocated by the ODRG for equivalence or substituted compliance.¹⁴²

Mr Giancarlo's view is that when the CFTC works cooperatively with foreign regulators it eliminates market disruption, reduces fragmentation and increases liquidity. Supranational and national swaps regulators must practice comity, that is, each jurisdiction should respect the laws and regulations of another jurisdiction and allow for substituted compliance when the first jurisdiction determines that the second jurisdiction's requirements are comparable to and as comprehensive as its own. While comity is granted out of respect, deference, or friendship, rather than as an obligation, it should be a cornerstone to ensure smooth operation of global swaps markets.

Effective international cooperation, and deference mechanisms would, in short, help to minimise the potential for regulatory arbitrage and fully and consistently implement the G20 2009 commitments.

Discussion Point #9

Improving equivalence could also work towards reducing regulatory arbitrage as it would make differences between jurisdictions more transparent to the various regulators who must assess differences in cross-border contexts.

ESMA Chairman Steven Maijoor in a 23 January 2017 address to the PRIME¹⁴³ 6th Annual Finance Conference touched upon EU third country policies in respect of OTC derivatives because they concern global markets. Under the equivalence approach, a country is considered equivalent when its rules are similar and compatible with EU rules. When the regulatory outcomes are determined to be equivalent, subject to certain conditions, an individual market participant can be recognised and provide its services in the EU. Under the equivalence mechanism, there is a heavy reliance on the home regulator. To date, ESMA has already recognised more than 20 CCPs from outside the EU under EMIR and are processing 25 other applications as of the end of January 2017.

ESMA raised in the 2015 EMIR Review¹⁴⁴ two concerns regarding the equivalence mechanism that it would like addressed. The first concern notes that some third countries adopt an overly restrictive "belt and braces" approach, e.g., US, that requires EU CCPs both to comply with their home jurisdiction (EU) regulatory requirements plus register to obtain authority to operate in the third country jurisdiction. On the other hand, the EU accepts this third country's regulatory authorisation of its own country's CCP as being sufficient to operate in the EU without an additional registration requirement for this CCP to obtain specific authority to operate in the EU. In other words, third country CCPs have benefited from the EU's equivalence system, while EU CCPs are still required to be authorised and to

¹⁴² Ibid.

¹⁴³ Panel of Recognised International Market Experts in Finance

¹⁴⁴ ESMA, EMIR Review Report no.4 ESMA input as part of the Commission consultation on the EMIR Review, 13 August 2015, ESMA/2015/1254, available at: https://www.esma.europa.eu/sites/default/files/library/2015/11/esma-2015-1254_-_emir_review_report_no.4_on_other_issues.pdf (accessed 26 February 2017).

be subject to the supervision of the third country regulator when they want to be active outside the EU which was not the intended result when designing the equivalence mechanism.¹⁴⁵

A second potential threat to equivalence expressed in the 2015 EMIR Review relates to the strong reliance on the home country regulator. Chair Maijoor asks, “do we have sufficient assurance that risks of the third country infrastructures’ activities in the EU are adequately assessed and addressed by the home regulator in the third country?”¹⁴⁶ He notes that “ESMA has very limited opportunities to see the specific risks that third country CCPs might be creating in the EU as we have very limited powers regarding information collection and risk assessment.”¹⁴⁷ This concern is especially true with respect to those third countries that play a significant role in the EU’s financial system. One cannot help but think that Maijoor is thinking of the implications of Brexit and the fact that the UK may soon become a third country.

Dr Andreas Dombret agrees with the views expressed in the Giancarlo-Tuckman SWAPS White Paper that a lot of work remains unsolved with respect to how to resolve an internationally active CCP.¹⁴⁸ In the EU, there is resistance from Member States to giving ESMA a more important role in the supervision of EU-based CCPs under a proposed resolution regime which will imply a fiscal impact on the Member State where the CCP is located. This does not consider that although the potential fiscal impact of a CCP resolution would remain with the Member State where the CCP is established, the economic impact of initial losses covered by prior recovery and resolution tools would have already affected other stakeholders across the EU. John Dizard suggests that “what worries the banks, especially European banks, is the sketchy legal and operational framework that exists for the “recovery and resolution” of a clearing house”¹⁴⁹ in the event such an EU based clearing house suffers an unprecedented loss.

Jan Friedrich and Matthias Thiemann argue that the decision of the UK to leave the EU may create a window of opportunity for those political actors who see an urgent need for common EU-wide supervision of common rules for CCPs due to issues of regulatory and supervisory arbitrage: “The current home-country supervision increases the threat of a supervisory race-to-the-bottom as it allows NCAs to interpret the implementation of common European rules in favour of their national CCPs leading to regulatory or even supervisory arbitrage.”¹⁵⁰

¹⁴⁵ ESMA, Keynote Speech of Steven Maijoor, Chair, PRIME Finance 6th Annual Conference, The Hague, 23 January 2017, ESMA71-844457584-329, available at:

https://www.esma.europa.eu/sites/default/files/library/esma71-844457584-329_prime_finance_conference_-_keynote_address_by_steven_maijoor.pdf (accessed 26 February 2017).

¹⁴⁶ Ibid.

¹⁴⁷ Ibid.

¹⁴⁸ Dombret, op cit.

¹⁴⁹ John Dizard, “Opinion: No-deal Brexit has big implications for European’s derivatives market”, FT, 5 October 2018, available at: <https://www.ft.com/content/25e53162-854d-37af-8496-2dfe06929362> (accessed 6 October 2018).

¹⁵⁰ Jan Friedrich and Matthias Thiemann, A new Governance Architecture for European Financial Markets? Towards a European Supervision of CCPs SAFE White Paper No. 53, June 2018, available at: <https://safe->

Nicolas Véron suggests while the EU supervisory architecture for banks has been swiftly centralised following the Financial Crisis (2008), the supervision of CCPs primarily remained with Member States despite the fact that the crisis starkly revealed the shortcomings and inherent risks of such a national-based approach.¹⁵¹ The UK withdrawal from the EU provides an opportunity to address these governance concerns over supervisory arbitrage with a unique moment to re-order material interests and location policies in such a way so as to benefit certain of the EU 27 Member States, e.g., those with the largest CCPs in the Eurozone such as France and Germany, at the expense of the UK.¹⁵²

When reaching “equivalence” deals, regulators must be innovative and flexible to reach equivalence deals cross-border that are based on the broad outcomes of regulations in, for instance, the US and EU rather than adhering to overly rigid rule-by-rule comparisons. A broad-based principles approach is the sort that was envisioned by the G20 and is essential to avoid a detrimental impact on liquidity.

Discussion Point #10

The 2017 ISDA Cross-Border Whitepaper offers a general framework for issuing comparability determinations that employs a risk-centred, outcomes-based approach which needs greater scrutiny to see if it could work as a sound model to resolve cross-border differences and reduce regulatory arbitrage possibilities.

ISDA has proposed a risk-based framework to be used by various jurisdictions to determine whether a particular jurisdiction achieves comparable outcomes with the rules of another jurisdiction. If a foreign jurisdiction meets such risk-based principles, under the framework such foreign jurisdiction should be granted substituted compliance in full. The 2017 ISDA Cross-Border Whitepaper examines in detail the regulatory requirements imposed by the CFTC which have the effect of extending the extraterritorial reach of US derivatives regulations beyond the US in ways that conflict with foreign national-level regulations in many instances.¹⁵³ Specific criticisms of the current approach of the CFTC have identified a number of issues with the CFTC Cross-Border Guidance related to jurisdictional overreach (already discussed in the section on private regulators above) and the substituted compliance approach used.

When the CFTC issues substituted compliance determinations under the Cross-Border Guidance for certain rules, it has done so on a rule-by-rule basis instead of applying an outcomes-based approach. The result of this is that CFTC ends up approving only portions of a foreign regulatory regime putting participants in the position of running duplicative and (in many cases) conflicting compliance programmes in order to meet various US and non-US requirements. Chairman Giancarlo agrees with this observation suggesting that the CFTC must develop an equivalence determinations process that focuses on achieving comparable

frankfurt.de/fileadmin/user_upload/editor_common/Policy_Center/SAFE_White_Paper_53.pdf (accessed 16 August 2018).

¹⁵¹ Nicolas Véron, Blog Post - Banking Nationalism and the European Crisis, 19 October 2013, available at: <http://bruegel.org/2013/10/banking-nationalism-and-the-european-crisis/> (accessed 16 August 2018).

¹⁵² Friedrich and Thiemann, op cit.

¹⁵³ 2017 ISDA Cross-Border Whitepaper, op cit.

regulatory outcomes in lieu of searching for elusive rule-by-rule exactitude.¹⁵⁴ ISDA suggests that the current approach has led to non-US firms ceasing to transact in US markets, thereby causing market fragmentation and diminished liquidity as well as a decrease in the competitiveness of US entities when compared to foreign firms.

In assessing foreign regulatory regimes for comparability, the only focus should be on whether the foreign regime has sufficient mechanisms in place to address or mitigate systemic risk.¹⁵⁵ This can be achieved by the establishment of broad regulatory principles that focus on risk-based measures (the cross-border principles) which can be used by the CFTC, the SEC, the Prudential Regulators and by foreign regulators as a tool to assess the comparability of foreign regulations. What must be borne in mind is that when the CFTC or other regulators assess the specific risk-related regulatory requirements of a particular jurisdiction it must also consider that particular jurisdiction's supervisory and/or industry practices as well. This is necessary in that there will always be variability in the ways different jurisdictions to address risk. Thus, the CFTC should not be quick to find a gap in the other jurisdiction's regulatory oversight or see it as a barrier to substituted compliance just because the foreign jurisdiction approach is not identical to that employed by the CFTC.

Where the CFTC finds other jurisdictions to be comparable to the CFTC regime, firms that operate in those other jurisdictions should be allowed to de-register with the CFTC and conduct their derivatives activities under local regulations, regardless of their organisational structure. A substituted compliance approach does not mean that there will be an instance where certain derivative activities whether taking place in the US or abroad will be unregulated, rather they will be regulated consistently across the globe through substituted compliance using differing methodologies and processes but harmonised to broad and consistent globally-agreed upon regulatory principles.

6. Conclusion, Recommendations and Further Research

a) Conclusion

In 2013, the differences between the US and EU/UK in terms of their respective approaches to the regulation of derivatives markets were significant in nature. Five years later, at this point in 2018, it can be said that, for the most part, the regulatory approaches achieve basically the same result. Since 2009, regulators in the US and the EU have been busy implementing the G20 reform agenda for regulating and overseeing OTC derivatives. On both sides of the Atlantic, regulators found themselves faced with the quandary of regulating domestic conduct in markets that are broadly international in scope. It is pleasing to note that regulators have now reached substantial accord on equivalency issues in respect of recognition of CCPs, margin requirements and data reporting requirements. Although there is some equivalence in CCP recognition, there is still an overall lack of

¹⁵⁴ CFTC, Speeches & Testimony, Remarks Chairman J. Christopher Giancarlo at the Eurofi Financial Forum, Vienna, Austria, 6 September 2018, op cit.

¹⁵⁵ 2017 ISDA Cross-Border Whitepaper, op cit.

equivalency between EU and US clearing rules. Finally, moving beyond the transatlantic focus of this paper, greater work internationally must be done to think through issues of CCP resilience.

As the US and EU/UK achieve greater alignment of regulatory oversight in respect of derivatives, the likelihood of regulatory arbitrage being a useful endeavour between these two jurisdictions has been reduced. With other major swaps jurisdictions adopting policies similar to those of the US and the EU/UK, organisations that would engage in regulatory arbitrage are more likely to look further afield to jurisdictions with less developed regulatory oversight of derivatives to gain benefit from such activity. This benefit would have to be weighed against the inherent risk that trading in such lesser regulated jurisdictions might pose.

While this summary identifies a number of critical areas where the US and EU/UK regulation of derivatives markets have become less divergent, there are structural problems in the way equivalence decisions are made that impede the ability of market participants in both jurisdictions to operate seamlessly. This problem is further compounded by an overly broad approach taken by the CFTC to capture within its regulatory orbit just about any entity or conduct that has some contact (no matter how tenuous it might be) with the US swaps markets or CFTC regulated entities. The end result of such regulatory overreach is that the added compliance costs involved makes the US swaps markets less attractive for non-US entities. This is one possible factor that can explain the rise of increased global fragmentation of derivatives markets.

The long-term effect that Brexit may have on the regulation of derivatives will depend on the new post-Brexit relationship that the UK and the EU agree upon. As has been seen here, most laws governing the derivatives market in the UK come from EU directives and regulations. The UK Government has indicated that it will use the EU (Withdrawal) Act 2018¹⁵⁶ as a stop-gap measure so that EU rules relating to financial services would continue to apply in the UK for the time being post-Brexit. This would be critical for the UK to maintain equivalent rules that would enable the UK to demonstrate to the EU that the post-Brexit UK regulatory regime for derivatives satisfies the equivalence requirements ESMA may mandate. With respect to the clearing and margin requirements set forth in EMIR, these standards come from the G20 international framework of the BCBS, the Principles for Financial Markets Infrastructure [PFMI] of CPMI-IOSCO¹⁵⁷ and the IOSCO mandatory clearing requirements, all of which the UK has signed up for separately from the EU, so these commitments would remain post-Brexit. While these issues are not insignificant, they pale in comparison with the chaos that would ensue in the event of a Disorderly Withdrawal.

Even if the UK were to enter into a Withdrawal Agreement and a transition followed on, it is not clear whether EMIR 2.2 and the added regulatory requirements for Tier 2 CCPs would in the end hasten the move of Euro-denominated OTC derivatives clearing from the UK to the Eurozone. It remains unclear whether the added protection of having prudential oversight

¹⁵⁷ BIS, CPSS-IOSCO, PFMI, available at: <https://www.bis.org/cpmi/publ/d101a.pdf> (accessed 8 November 2018).

of Euro-denominated clearing institutions operating from within the Eurozone outweighs the added costs that such a wholesale relocation might entail for the derivatives industry in terms of the immediate upheaval and higher cost of capital that might result from operating in smaller capital markets on the Continent.

An irony to consider is that the post-Financial Crisis reforms of financial markets regulation in the EU through EMIR and MiFiD were designed to harmonise financial services regulation across the Single Market so as to eliminate the possibility of regulatory arbitrage within the Single Market among the different Member States. Given this was the mandate, it is hard to imagine the EU accepting any future relationship with the UK that would give the UK an unfair advantage over Member States to engage in regulatory arbitrage from outside the Single Market.

The Trump Administration has made a number of positive statements to the effect that it wishes to eliminate some of the more ill-conceived aspects of global swaps regulation enacted under Dodd Frank. Chairman Giancarlo calls the initial regulation adopted by the CFTC after the Pittsburgh G20 recommendations the “SWAPS 1.0 Regulation”.¹⁵⁸ He draws an analogy between SWAPS 1.0 Regulation and a first version software application. While both are functional, they each contain significant bugs and flaws that have to be addressed. Giancarlo now proposes to replace SWAPS 1.0 Regulation with a new version, “SWAPS 2.0 Regulation”, which “will better balance systemic risk resiliency with vibrant and durable financial markets essential for sustainable economic growth and broad-based prosperity.”¹⁵⁹ It must be borne in mind that the task of reforming US swaps regulations as envisioned by Chairman Giancarlo is a formidable one which cannot be achieved except through coordinated and sustained effort on the part of the CFTC, its commissioners, Congress, the rest of the Trump Administration and the swaps industry as a whole, and the process could take years to achieve.

An essential element of SWAPS 2.0 Regulation is a recognition that current CFTC regulation must be reformed so as to eliminate the rationale for non-US market participants to engage in efforts to escape the CFTC’s swaps trading rules. This might offer a solution to reduce the fragmentation occurring in the global swaps trading pool that is now isolating US persons from participation in liquidity pools worldwide. However, a reassessment of the US approach to cross-border transactions will require “buy-in” from international counterparts who will have to resist the temptation to impose their own rules on an extraterritorial basis such as that envisioned by EU’s EMIR 2.2 reforms. It is fair to say that if EMIR 2.2, once finally enacted, is overly restrictive in terms of oversight of Tier 2.0 CCPs then the likelihood that SWAPS 2.0 Regulation reforms will curb CFTC extraterritorial overreach will be greatly reduced. EMIR 2.2 and SWAPS 2.0 Regulation will severely test whether the progress made in recent years to reduce the extraterritoriality application of various jurisdictions laws in the derivatives area will hold.

¹⁵⁸ The 2018 CFTC Cross-Border Swaps White Paper. op cit., 11.

¹⁵⁹ Ibid.

b) Recommendations

This research suggests possible solutions for a collaborative approach which include:

- **Concerted regulatory effort to eliminate segregated liquidity pools:** Congress and the CFTC need to act quickly to address the US “scarlet letter” problem so that transacting with a US person does not automatically subject transactions and its parties to US regulation
- **Brexit and derivatives contracts:** Politicians and regulators in the EU and UK need to look carefully at the concerns raised by the BoE on the potential problems Brexit will cause to the derivatives markets especially the contracts issue. Any Brexit outcome that harms the smooth operations of the derivatives markets would be an irresponsible one. ESMA’s proposal (announced 8 November 2018) to provide a year-long exemption to prevent disruption to thousands of uncleared derivatives contracts in the event of a “no deal” Brexit is a positive move in this direction.
- **Euro clearing in London:** Recent statements from the EC suggest that the EU will take necessary steps to work with the UK to avoid disruption to derivatives clearing in the event of a “no deal” Brexit. However, an accord must be reached between the individual banking regulators in France, Germany and the UK to address the challenge that Brexit poses to the EU by having a systematically important financial institution closely linked to the stability of the Eurozone being located in a “third country”. The financial incentives for the UK to offer the right incentives to the EU suggest this is possible.
- **More work on CCP resolution issues and harmonisation of insolvency regimes:** More work needs to be done to harmonise cross-border insolvency, so the same results can be obtained, regardless of jurisdiction. There is an urgent need to think through the resolution implications of large CCPs now before such an event becomes a reality.
- **EMIR 2.2:** The EC needs to tread very carefully in developing a Tier 2 CCP regulatory regime that does not undo the progress towards comity that has been made to date with the US and other national regulators.
- **SWAPS 2.0 Regulation:** There is an onus on the CFTC to undo the damage done by its overly prescriptive approach to equivalence determinations. SWAPS 2.0 Regulation should be used to truly implement greater regulatory deference so as to further open up the CFTC regulatory regime to European firms and markets in exchange for the CFTC recognising the power and authority of EU authorities to regulate and supervise the European market with limited involvement from the CFTC.
- **Other Swaps Jurisdictions:** If the CFTC and the EU can successfully implement a new and innovative mutually deferential approach it will lead to the other significant swaps’ jurisdictions, e.g., Australia, Canada, Japan, Singapore, etc., completing the global swaps reform agenda in a manner that can be harmonious and effective without fragmenting world markets.

- **Last Clear Chance:** Reconsidering EMIR 2.2 and completing SWAPS 2.0 Regulation represent the last clear chance for global regulators to solve the fragmentation of derivatives markets before the schism becomes irreversible.
- **Implement the 2017 ISDA Cross-Border Whitepaper:** The key recommendation that a risk-based framework should be used by various jurisdictions to determine whether a particular jurisdiction achieves comparable outcomes with the rules of another jurisdiction combined with a substituted compliance approach which should be followed if this is the case is a sound one that could resolve many of the problems of extraterritorial overreach and liquidity fragmentation.
- **Understand the dividing line:** Regulators should understand the dividing line between rules that mitigate systemic risk and those which assure trading, market conduct and reporting requirements. While it is essential that various jurisdictions ensure that all jurisdictions have in place roughly similar standards to mitigate systemic risk, e.g., to avoid a catastrophic event such as a CCP failure, an outcomes-based approach to trading, market conduct and reporting requirements might be better left in the remit of the local regulator in the absence of a compelling cross-border interest to not do so.
- **Pooling of sovereignty:** To develop a regime that truly works off a substituted compliance basis, the major jurisdictions involved with derivatives will need to consider pooling their sovereignty to create an oversight framework and a mediation mechanism to resolve extraterritorial complexities on a going forward basis.

The recommendations made here are ambitious in scope but this does not mean that national and supranational regulators should shy away from addressing the tough problems that the extraterritorial aspects of derivatives regulation raise. Though the political appetite for such an approach may not exist 10 years on from the Financial Crisis, the need to develop regulations at an international level in a comprehensive fashion remains.

c) Further Research

A full study of the implications of Brexit upon the transatlantic regulation of OTC derivatives is beyond the scope of this paper but it will be well-worth reviewing once a final settlement is reached in respect of financial services between the UK and EU. Similarly, if the CFTC is successful in reforming or repealing the more burdensome aspects of how derivatives are regulated in the US, this too may have implications for the transatlantic regulation of OTC derivatives and merit scholarly re-examination at a later date. Some modelling as to how the risk-based framework proposed by the 2017 ISDA Cross-Border Whitepaper might work out in different scenarios to prove the efficacy of such an approach would be useful. This paper does not address SEC regulation of security-based swaps [SBS] which is a separate specialised area of the US regulatory scheme for derivatives as this would make this research too broad to undertake. Nonetheless, SEC regulated SBS do need to be considered in the overall context of extraterritoriality as well.

At a later date, a longitudinal study needs to be done to examine whether possible incentives for market participants to arbitrage between jurisdictions have actually been reduced over time through implementation of substituted compliance. As this paper focuses primarily on the US and the EU (along with the UK), such a longitudinal study should, however, be broadened to include both the major swaps jurisdictions and emerging markets to see if the 2009 G20 reforms are being implemented worldwide in a manner consistent with the desire to eliminate regulatory arbitrage in the derivatives sector.

A more theoretical enquiry, perhaps in the form of an academic journal article, would help to address the broader context of what is driving the political actors and offer answers to unresolved questions such as:

- First, which country would pay in the event of a catastrophic CCP failure that has global dimension?
- Second, is the CCP still the optimal model? While it does allow for netting and collateral assembly in a single location, the current context of a fragmented market suggests shortcomings that might be better resolved through a collection of “super-banks” where OTC contracts could be left to sit that might better address risk and market fragmentation.
- Third, maybe it is high-time we recognise that extra-territoriality is wholly-unavoidable. The very nature of a derivative transaction, e.g., a currency SWAP, is by itself cross-border. So when we try to keep such an instrument under the control of any one jurisdiction this act in and of itself has extra-territorial effect in other jurisdictions that may be affected by it.

Finally, the same academic journal article could offer a more systematic structure that would offer policymakers a small set of concepts on extraterritoriality in the context of derivatives that would enable them to address the larger set of issues raised in this paper in a more hierarchical and ordered manner. The rapidly transforming environment in which the extraterritoriality and derivatives debate is taking place makes this task so elusive to achieve yet so necessary to be done.

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Glossary of Terms

AIMA	Alternative Investment Management Association
BCBS	The Basel Committee on Banking Supervision
BIS	Bank for International Settlements
BoE	Bank of England
BREXIT	Withdrawal of the UK from the EU
CCP	Central Clearing Counterparty
CCPs	Central Clearing Counterparties
CEA	Commodity Exchange Act
CFMA	Commodity Futures Modernization Act of 2000
CFTC	Commodities Future Trading Commission
CJEU	Court of Justice of the EU
CPMI	Committee on Payments and Market Infrastructures
CPSS	Committee on Payment and Settlement Systems
DCM	Designated Contract Market
Dodd-Frank or Dodd-Frank Act	The Dodd–Frank Wall Street Reform and Consumer Protection Act (Pub.L. 111–203, H.R. 4173)
DEXEU	UK Department for Exiting the EU
Disorderly Withdrawal	The withdrawal of the UK from the EU without entering into a Withdrawal Agreement
DTCC	Depository Trust & Clearing Company
EC	European Commission
ECB	European Central Bank
EBA	European Banking Authority
EMIR	European Market Infrastructure Regulation
EMIR 2.2	June 2017 EC Proposal to Amend EMIR to Enhance Supervision of CCPs
ESMA	European Securities and Markets Authority
ESA	European Supervisory Authority
EU	European Union
EU27	Member States of the EU Other the UK
FED	Federal Reserve
FCA	Financial Conduct Authority
FCIC	Financial Crisis (2008) Inquiry Commission
FIA	Futures Industry Association
FSB	Financial Stability Board
FX	Foreign Exchange
G20	Group of Twenty
HC	House of Commons
HL	House of Lords
ISDA	International Swaps and Derivatives Association
IM	Initial Margin
IOSCO	International Organization of Securities Commission
IRD	Interest Rate Derivatives
IRS	Interest Rate Swaps
LCH	LCH Clearnet
LEI	Legal Entity Identifier
LSE	London Stock Exchange plc
MiFID	Markets in Financial Instruments Derivatives
MiFID II	Markets in Financial Instruments Derivatives II
MIFIR	Markets in Financial Instruments and Amending Regulation
MOU	Memorandum of Understanding
MPOR	Margin Period of Risk
MTF	Multilateral Trading Facility

NCA	National Competent Authority
ODRG	The OTC Derivatives Regulators Group
OTC	Over the Counter
PFMI	Principles for Financial Market Infrastructures
PRIME	Panel of Recognised International Market Experts in Finance
Pro-Reform White Paper	2015 Giancarlo White Paper
Prudential Regulators	the US Office of the Comptroller of the Currency (Department of Treasury), the Board of Governors of the Fed, the Federal Deposit Insurance Corporation, the Farm Credit Administration and the Federal Housing Finance Agency
RTS	Regulatory Technical Standards
SEC	US Securities and Exchange Commission
SB-SEF	Security-Based Swap Execution Facility
SBS	Security-Based Swaps
SDR	Swap Data Repositories
SEF	Swap Execution Facility
Giancarlo-Tuckman SWAPS White Paper	Giancarlo-Tucker SWAPS Regulation 2.0 - 26 April 2018 – White Paper
TRs	Trade Repositories
UK	United Kingdom
US	United States
VM	Variation Margin
Withdrawal Agreement	An agreement to be entered in between the EU and UK concerning its relationship after the Withdrawal Date
Withdrawal Date	The date on which the UK withdraws from the EU (scheduled for 29 March 2019)